NATIONAL CREDIT UNION ADMINISTRATION OPERATIONS AND BUDGET

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

JULY 23, 2015

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NATIONAL CREDIT UNION ADMINISTRATION OPERATIONS AND BUDGET

Thursday, July 23, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:20 p.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Pearce, Posey, Fitzpatrick, Luetkemeyer, Mulvaney, Pittenger, Barr, Rothfus, Guinta, Tipton, Williams; Clay, Scott, Maloney, and Sinema.

Also present: Representatives Royce and Fincher.

Chairman NEUGEBAUER. The Subcommittee on Financial Institutions and Consumer Credit will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "National Credit Union Administration Operations and Budget." Before I begin, I would like to note that there are several National Credit Union Administration (NCUA) staff members here today. And committee policy is one staff member per witness. This is to ensure public participation. In the event we have more public audience members come in, we will ask some of the NCUA staff to head to our overflow room upstairs.

I would like to thank Chairman Matz for being flexible with our schedule. As you know, we were scheduled to have this hearing tomorrow. And then the leadership decided we weren't going to be here tomorrow. The Chair was gracious enough to change her schedule. And we appreciate that.

I am going to now recognize myself for 5 minutes for an opening statement. Good afternoon to the committee. Financial institutions are the backbone of Main Street America. Credit unions particularly share a unique relationship with communities. After all, they are the core of the cooperatives. They help bring unserved and underserved customers into the financial mainstream. They provide the first credit card for young adults trying to build credit. They help the first-time home buyer purchase the home they have been dreaming of. And often they are the last corporate citizen left standing in many rural districts, including many areas of my own district. Perhaps most importantly, though, they are experts on relationship banking, helping to customize products to fit the needs of their customer base.

Unfortunately, credit unions, like community banks, are suffering from the one-size-fits-all regulatory actions of the Federal regulators. For example, some credit unions now undergo stress testing like their larger bank counterparts. Because of this increased regulatory burden and the related compliance costs, we have seen a massive consolidation of credit unions, and inflexible product standardization, which has limited some of the customer choices.

Data from the National Credit Union Administration shows that we lost nearly 1,000 credit unions between 2010 and 2014. This trend presents a threat to communities across the country, especially rural and semi-urban areas such as the 19th District of Texas. I worry that without some regulatory flexibility, credit unions will be less able to meet local needs, will stop offering products, or consolidate. To me, this signals problems in the health of the credit union industry.

Today's hearing will mark the first time since 2011 that the NCUA Chair has testified before Congress. As with any Federal agency, it is imperative that we conduct vigorous oversight of budgeting and operations. This ensures that the money paid into the system by the credit unions is being spent appropriately and that the taxpayers remain protected by a strong Share Insurance Fund. Further, it ensures rigorous debate of policy decisions made by the NCUA.

NCUA has undertaken significant regulatory policy changes under Chair Matz's leadership. And it is necessary to understand how these actions are affecting the health of the credit union system. Today, our Members will get to tackle both of those tasks. During today's hearing, I am hopeful that Chair Matz will address two issues in particular.

First, NCUA's budget has increased each year since 2008, sometimes in double digit percentages. However, during the same time, the number of credit unions has dropped by nearly a quarter. I hope to hear Chair Matz outline clear justifications for this budget increase that does not appear to be matched to other supervisory demands.

Second, I am concerned that the NCUA has not appropriately outlined how it will address the industry's best practice of using capital buffers on top of regulatory capital requirements. The NCUA must clearly signal how it plans to supervise this industry's best practice to ensure capital is efficiently put to use and that there remains robust and safe credit availability for our constituents.

I look forward to hearing Chair Matz's perspective on these important issues and more during today's hearing. Thank you.

And now, with that, I yield to the ranking member of the subcommittee, Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

And thank you, Chair Matz, for your testimony. And, Mr. Chairman, I would like to relay something pertaining to your remarks about credit unions and what purpose they serve. As a young adult with my first job, I applied for an auto loan with my community bank, where I had checking and savings accounts, and was denied the loan and was forced to go join the Wright Patman Credit Union, where I was approved for the loan, which I paid off in half the time. So they took a chance on me. And I am certainly going to take a chance on credit unions. So thank you.

Like most banking regulators, the NCUA's budget is derived from the entities that they regulate, an arrangement designed to insulate the Administration from political pressure. Such an arrangement should not, however, trade the pressure of the congressional appropriations process for pressure from the credit union industry to shape their budget, an arrangement that was agency policy from 2001 to 2008, but that undermined the Administration's ability to respond to financial crises and its ability to prevent losses to the Share Insurance Fund.

I look forward to a discussion that actually reflects the concerns that credit unions have in their day-to-day core operations, whether they be proposals to allow them to raise supplemental capital or expand member business lending or other regulatory relief proposals. I look forward to hearing more about how we can work with the NCUA to ensure that the regulatory environment for our credit unions is one that allows them to thrive but that also protects members and the Share Insurance Fund. And thank you again for your testimony and your leadership.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from New Hampshire, Mr. Guinta, is recognized for 1 minute.

Mr. GUINTA. Thank you very much, Mr. Chairman.

Good afternoon, Chair Matz.

It is a privilege and an honor to be representing the First Congressional District of New Hampshire, where the first ever credit union was founded in the United States. In 1908, St. Mary's Bank emerged in a small town called Manchester, which is my hometown. Since then, Manchester has grown to be the State's largest city. And surrounding the City came more credit unions and community banks. Now there are 27 credit unions in New Hampshire, 14 of which are in my district.

However, community banks and credit unions have been consolidating at an alarming rate. According to the quarterly data posted on the NCUA's website, credit unions have declined 52 percent from 1990 to now. I sit here and ask myself, why is this happening to our community financial institutions? Consumer choice, I think and hope, is something that we as Americans all value. However, we have seen this negative trend continue and even be enhanced, I think, by rigorous regulatory requirements by the Dodd-Frank Act.

You, Madam Chair, called 2015 the year of regulation relief. And I certainly hope that is true. I look forward to working with you in that approach because I think the harmful regulations our financial institutions have faced need to be addressed immediately. So I very much thank you for coming here today and working with us. And I look forward to hearing your testimony.

I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentleman.

The gentlewoman from Arizona, Ms. Sinema, is recognized for 1 minute.

Ms. SINEMA. Thank you, Chairman Neugebauer and Ranking Member Clay, for holding this very important and timely hearing.

As you may know, Congressman Mulvaney and I are sponsors of bipartisan legislation to bring greater transparency to the National Credit Union Administration's budget process by requiring a public hearing on the budget before adoption. This legislation is simple and straightforward. It would require NCUA to publish a draft budget on an annual basis and then hold a public hearing with notice and opportunity for public comment before the NCUA Board makes a final determination on how funds are spent.

As NCUA is funded almost exclusively through fees assessed on credit unions, we believe the public and the credit unions that are regulated should have an opportunity to weigh in as NCUA considers its annual budget.

Between 2001 and 2008, NCUA held public hearings. I look forward to hearing from today's witness about why these hearings have been discontinued and how the agency can improve the current budget process to make it more open and transparent.

Again, thank you, Chairman Neugebauer and Ranking Member Clay for holding today's hearing.

And thank you, Chair Matz, for sharing your expert view with us today.

Chairman NEUGEBAUER. I thank the gentlewoman.

Today, we welcome Debbie Matz, the Chair of the National Credit Union Administration. Chair Matz was nominated by President Barack Obama to serve as the eighth Board Chair of the National Credit Union Administration after confirmation by the U.S. Senate on August 7, 2009. She was sworn in as the Chair on August 24, 2009. Ms. Matz served on the NCUA Board from January 2002 to October 2005, and is the first NCUA Board member to return for a second turn. She was nominated for her first term by President George W. Bush. As the NCUA Chair, Ms. Matz heads the independent agency overseeing the regulation and supervision of the Federal credit unions and the National Credit Union Share Insurance Fund (NCUSIF), which protects the accounts of over 6,500 federally-insured credit unions serving more than 96 million members, and managing more than $1.1 trillion in assets.

Chair Matz, we are glad to have you here. You are now recognized for 5 minutes. And without objection, your written testimony will be made a part of the record.

STATEMENT OF THE HONORABLE DEBBIE MATZ, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. MATZ. Thank you. Good afternoon, Chairman Neugebauer, Ranking Member Clay, and subcommittee members. Thank you for inviting me to appear before you.

When I came back to NCUA as chairman in 2009, in the wake of the Great Recession, the credit union system was on the brink of collapse. To prevent this, we developed an unprecedented mechanism to securitize $50 billion in toxic corporate credit union assets. Within a few months, 351 consumer credit unions, holding nearly $52 billion in assets, were close to failing.

Compounding the situation, NCUA's budget and staffing in the years leading to the crisis had not kept pace with credit unions' growth and increasing complexity. In fact, during the 7 years leading up to the financial crisis, NCUA cut a total of 91 staff positions, even though credit union assets had increased by 73 percent. During the same period, NCUA's budget, as a percentage of credit union assets, declined by 35 percent. NCUA was understaffed and underresourced.

We soon rectified these problems while preventing any unnecessary budget and staffing growth. To efficiently manage shifting workloads, we reallocated existing resources wherever possible. For example, to provide more supervision to credit unions that pose greater risks to the Share Insurance Fund, we have reallocated exam hours away from smaller credit unions towards larger ones, rather than simply adding new examiners.

The NCUA budget is developed from the bottom up each year, using a zero-based budgeting process. Every office in the agency must justify its staffing level and each expenditure. Through this process, we efficiently allocate resources towards priorities detailed in NCUA's strategic plan. The full plan and budget details are posted on our website.

NCUA leads financial institution regulators in budget transparency. Our website contains a dedicated budget resource center that includes annual fund audits, budget summaries and slides, office-by-office spending plans, and a host of other budget information exceeding what other financial regulators disclose.

Among my top priorities are providing transparency and communicating effectively with all stakeholders. To this end, I have held 18 in-person listening sessions, hosted 11 online townhall webinars, and crisscrossed the country speaking to and meeting with tens of thousands of credit union officials representing every State. This is one of the most important aspects of my job because I receive the most useful feedback when I hear from the people who actually run credit unions.

I heard their comments about our exam process. I heard we needed to target regulations to risks. I heard our member business loan rule was too prescriptive. I heard we should remove the cap on fixed assets. I heard we needed to improve how we designate low-income credit unions. I heard we needed to streamline how we approve fields of membership. And I heard we needed to reduce burdens on small credit unions.

So, I am here to tell you we listened, and we acted. We relieved unnecessary burdens as we have modernized our regulations. The NCUA Board remains committed to providing regulatory relief that does not compromise safety and soundness. We continue to act on all practical suggestions as we move toward a principles-based regulatory framework and enhance credit union powers within our authority.

As NCUA eases regulatory burdens and responds to emerging risks, our supervision budget and staff must keep pace with credit unions' growth and complexity. Reports by GAO and our inspector general underscore this need.

Today, key credit union system metrics have recovered to pre-crisis levels. And, notably, the percentage of assets in troubled credit unions has been reduced to a manageable level, down to just 1 percent. The recovering economy is, in part, responsible for the improvements in credit union performance. Credit is also due to the CEOs, managers, and boards who make tough choices to keep their credit unions solvent, as well as the NCUA staff who supervised credit unions under very difficult circumstances.

We are now on the right track. Both the credit union system and NCUA are in remarkably better condition than when I became chairman. I will continue working to protect the safety and soundness of credit unions and protect the 100 million account holders who are federally insured by NCUA. I look forward to your questions.

[The prepared statement of Chairman Matz can be found on page 32 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Chair Matz, the NCUA approved a budget in 2015 by a vote of 2 to 1 of $279.4 million, an increase of 4.2 percent. Over the last 7 years, the average increase in the budget has been about 8.49 percent and is much—one, year I think it was 13 percent. This kind of contrasts dramatically from the budget, say, of the FDIC, which has been decreasing its operating costs for the last 5 years, including 3 percent for 2015. And they cut 325 positions this year.

NCUA has reported to Congress that credit unions performed well during the financial crisis and continue to grow and serve their members. Further, the NCUA has previously justified these budget increases by saying the credit unions have become more complex. Can you kind of walk us through this pretty large budget increase, how it is justified, and kind of elaborate how credit unions have become more complex?

Ms. MATZ. Certainly. And to your point about the FDIC versus the NCUA budget, FDIC has two budgets: a resolution budget; and an operating budget. During the crisis, the resolution budget went up very dramatically and has been coming down. But when you look at their budgets combined or their operating budget in isolation, it has been very comparable to ours throughout the past probably 5 or 10 years. So we are on parity with the way the FDIC has been operating in terms of its budget increases.

But during the crisis, we lost 102 credit unions, which cost the credit union system about $750 million. We have been doing everything we can to make sure that doesn't happen again. I believe that the reason we lost those 102 credit unions was because our staff simply did not have the resources to supervise them effectively heading into the crisis and during the crisis because we were down by 91 employees at the time that I got there. And so, it was my intent to make sure that we have the resources that we need to protect the safety and soundness of the growing industry.

In front of you, you will see slide 3, which shows you our budget as a percent, per million dollars, of federally-insured credit union assets. And you can see that it was way down, when we had the budget hearings. It was way down. And it has trended up somewhat. But it is still considerably lower than where we were in the year 2000. At that point, our budget was $328 per million dollars of federally-insured assets and now it is $249. So, I think we are operating very effectively.

But we need to keep ahead of the complexity of the industry. I have said many times that NCUA should not be holding the industry back. And the industry, the credit union industry, needs to stay competitive. And so, they need to be providing electronic services to their members. They want—they asked for and we gave them derivative authority to hedge interest rate risk. They need more flexibility in the way they do business. Just today, at our Board meeting, we eliminated the cap on their fixed-asset investments.

Chairman NEUGEBAUER. Let me change direction here, because we have a limited amount of time. A review of the NCUA's inspector general materials, loss reviews for the limited number of credit union failures during the financial crisis, reveals that the NCUA examiners did routinely identify problems on a timely basis. In other words, the examiners, it is not the issue that we had enough examiners, but the problem, and they indicated they did uncover the problems, but what the report did indicate was that it wasn't a function of not detecting the problems but the proper follow-up. And so, it would lead one to believe that what we don't need is more examiners, but evidently, we need more competent examiners. What is your response to the report that said that your folks found out the problems but didn't deal with them appropriately?

Ms. MATZ. In fact, there was a series of material loss reviews. So, it depends on which one you look at. But their capping report, which summarized all of the material loss reviews, said we were not detecting problems early enough. And they did not comment on our staffing level. But we have held the staffing level constant for the past 4 years. So, our intent is not to increase the staff. We have been reallocating our workload, so that we have taken examiners from small credit unions and reassigned them to larger credit unions so that we can do our job effectively without increasing the staff.

Chairman NEUGEBAUER. So the number of credit unions has decreased by 25 percent, but the budget has gone up. That seems to be contradictory.

Ms. MATZ. It is not contradictory. In fact, because the number of assets and the complexity of the credit unions has gone up more rapidly than the number of credit unions has declined. And if you have more complex institutions, you need to have staff who are well-trained to supervise those institutions.

Chairman NEUGEBAUER. My time has expired.

I now recognize the gentleman from Missouri, Ranking Member Clay, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

H.R. 2287 would provide credit unions and their trade associations the opportunity to participate in predecisional hearings on the NCUA's operating budget. It is my understanding that, relative to other financial regulators, the NCUA is a leader amongst its peers in providing transparency around its budget process.

Madam Chair, describe the information that you already make available to the public concerning the NCUA's budgeting process and how would your budget transparency efforts compare to those of other financial regulators?

Ms. MATZ. Thank you for that question. When I came onto the Board in 2009, one of my top goals was to improve transparency and communication with all of our stakeholders. And to that end, I began to hold listening sessions around the country. I have held 18 of them. I started holding virtual townhall meetings through webinars. I have held 11 of them. In fact, I have one coming up on Tuesday that was planned quite a while ago. And I have crisscrossed the country meeting with credit unions. I find it more effective to hear from the people who run the credit unions.

When we held the hearings when I was on the Board last time, typically what we had were three or four representatives from the trade associations who read statements prepared by the trade associations. And the statements were consistent across the witnesses and through the years. And the message was cut your budget, cut the number of examiners, cut the time you spend in the credit unions. That was not productive. It was not constructive in terms of developing our budget.

What is constructive is when I go out and talk to the credit union officials and I find out what things are really on their minds and how we can respond so that they can do their jobs better. But in terms of transparency, we have a budget resource website that has all of our budget advisory memos that are given to each of the Board members, describing in detail what the budget is. We have line-by-line budgets for each office in the agency. We have our audits from our accounting firms. It goes on. There are dozens of things on our website. I don't really think there is much on our website that doesn't answer every possible question, including frequently asked questions. No other financial institutions regulator does that. And no other financial institutions regulator holds hearings on its budget.

Mr. CLAY. How would enhanced disclosure of the NCUA's operating budget and the other funds it administers support the core operations of credit unions? I am just curious.

Ms. MATZ. I don't think it would enhance our budget process at all. In fact, our budget has a minimal impact on the credit unions themselves. Our budget, as a percentage of the actual credit union expenditures, is less than 0.02 percent. It is a very minimal amount. So, I don't think they are adversely impacted at all by our budget.

Mr. CLAY. In your experience in interacting with credit unions in the field, have you ever gotten requests from the credit unions themselves about further transparency into the NCUA's budget or the other funds that it administers?

Ms. MATZ. I can tell you, as I said, I have crisscrossed the country and met with tens of thousands of credit union officials. And I really can't remember getting a question about the transparency or really about our budget in general. Now that the trades have whipped this up as an issue, you might be hearing about it. But I can tell you in all the years that I have been on the Board, meeting with credit union officials, this is not one of the issues that has come up.

Mr. CLAY. Interesting. I appreciate your responses. And, hopefully, we all understand that this could be motivated by the trade associations.

Mr. Chairman, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Florida, Mr. Posey, is recognized for 5 minutes. Mr. Posey has stepped out, so we are going to recognize the gentleman from Missouri, Mr. Luetkemeyer, for 5 minutes. He has also stepped out.

Let's go to the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. I thank the chairman.

Chair Matz, I get a lot of questions back home about the overhead transfer rate, the amount of money that you all take out of the security insurance fund to use for your overhead. You mention it in your testimony and say that the operating budget is reimbursed from the State insurance fund. That is the OTR, so the overhead transfer. You go on to say that your methodology for calculating the overhead transfer rate was validated in 2011 and 2013 by PricewaterhouseCoopers. On your website, and I see you have something there as well, it says that: While PricewaterhouseCoopers made recommendations to improve the process on the OTR, overall, they determined that the methodology was sound and reasonable.

So I did something that I think is fairly reasonable, which is I went to your website to get the overhead transfer rate review, which is the one that was done for you by PricewaterhouseCoopers that you mentioned in your opening testimony and on the website. And when I turned to the first section, which I think is a fairly reasonable section for somebody to go to to try and get up-to-speed on it, the executive summary, I got to page 5, and it says: "The findings and conclusions of this study, which are based on an analysis of available facts and circumstances, are presented below." And I get an entirely redacted section. In fact, that happens a lot. There is a bunch of different places that are redacted. I think 15 pages are redacted.

I tried to figure out why that was. And someplace on the website, you all also mentioned Section (b)(4) of the Freedom of Information Act. You go to read that, and it says that you don't have to—or it is okay to redact essentially things that are trade secrets and commercial or financial information obtained from a person or privileged or confidential material. All of which is cool. Okay.

Until I get to this, which is the unredacted copy of your agreement. By the way, did you know that I have this as you sit there today?

Ms. MATZ. I didn't know that you had it. I had no idea.

Mr. MULVANEY. Okay. You did not know that I have it. Okay. I am going to read to you one of the redacted sections that you all cut out of the conclusions of the executive summary regarding transparency. Again, you can't get this publicly. But you can get it if you get the unredacted version. It says: "Based on the PricewaterhouseCoopers review, the OTR methodology was considered lacking in terms of the extent to which the classification of NCUA's activities between insurance and regulatory represents a consensual view."

It goes on to say that: "Further, there was found to be dissatisfaction within the industry with respect to NCUA's efforts to communicate and explain the OTR methodology in adequate detail. It is recommended that the NCUA should consider providing more visibility on how it characterizes its activity to the different industry groups and credit unions and possibly solicit their feedback with regards to the reasonableness and accuracy of the classification."

How is any of that a trade secret?

Ms. MATZ. Sir, I should point out to you that when I learned, just recently, that that redacted version was on our website—and I have to say I was somewhat shocked by it myself—I discussed it with the staff and the unredacted version will be going up. However, I should point out—

Mr. MULVANEY. When did you have that conversation?

Ms. MATZ. Yesterday.

Mr. MULVANEY. Yesterday. Why did you have it yesterday? What happened yesterday to prompt you to have a discussion with your staff?

Ms. MATZ. I guess it was just a discussion of the things that were on our website about—

Mr. MULVANEY. It had nothing to do with this hearing? You just happened to be randomly looking at your website yesterday and decided—

Ms. MATZ. No. No. I was discussing with the staff what we have on our website that affects our budget and wanted to see it.

But what I wanted to say is that subsequent to that, in 2013, we did have a study by PricewaterhouseCoopers—

Mr. MULVANEY. I got that. And if I get a chance to get to that, I will. But let me ask you the question, who made the decision to redact the 2011 report before it went up on the website? Was that you? Or was that somebody else?

Ms. MATZ. Our general counsel's office.

Mr. MULVANEY. Did you approve that decision?

Ms. MATZ. I wasn't aware of it.

Mr. MULVANEY. Do you believe that information to be a trade secret?

Ms. MATZ. I don't.

Mr. MULVANEY. And your answer is, you are going to go ahead and put it up?

Ms. MATZ. Yes.

Mr. MULVANEY. By the way, the irony of redacting something that says you should be more transparent—

Ms. MATZ. Yes. I got the irony.

Mr. MULVANEY. I got you. Thanks very much.

Another thing you redacted, by the way, later in the document, it says that: "NCUA should also check if the OTR decisions are subject to the Administrative Procedure Act and if formal notice or comments are required on its OTR calculation process and results."

I won't ask you if that is a trade secret. You will probably say it isn't, and it is going to be on your website soon anyway. Let me ask you, have you done that?

Ms. MATZ. Do you want me to answer the question?

Mr. MULVANEY. No. I want you to answer the question I have asked you, which is, have you done what PricewaterhouseCoopers asked you to do in 2011 regarding the Administrative Procedure Act?

Ms. MATZ. Our general counsel has advised that we do not need to publish it. However, in my written testimony I indicate that we are, in fact, going to publish the formula for review and comment.

Mr. MULVANEY. Lastly, you mentioned earlier that the budget was on your website. I have your budget. Thank you for sending it to me. It only took me 18 months to get it. I am really excited about having it. I got it yesterday. I appreciate that. Is the line-by-line budget that you gave me yesterday available on your website?

Ms. MATZ. Not at this time.

Mr. MULVANEY. When it will be available on your website?

Ms. MATZ. We can put it up as soon as—

Mr. MULVANEY. Finally, there is one thing redacted in the reports—I won't read it verbatim because I don't have time—it says that you should look at, explore future avenues of communication with the folks that you regulate.

Would you agree that my bill with Ms. Sinema, going back to the original process of having input, direct input, and meetings on your budget could be one avenue by which you could increase your communication with the people that you regulate?

Ms. MATZ. It would increase the communications, but it would not be effective.

Chairman NEUGEBAUER. The time of the gentleman has expired.

Mr. MULVANEY. I am certain that you think it won't be. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I now recognize the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Chair Matz, let me make sure now, the NCUA, the National Credit Union Administration, your budget is funded through fees from your credit unions across the country, is that correct?

Ms. MATZ. That is correct.

Mr. SCOTT. So it is safe to say the credit union members themselves bear the total cost of the agency's operations and expenses?

Ms. MATZ. That is correct.

Mr. SCOTT. Okay. Let me ask you this, do you hold public hearings for your budget?

Ms. MATZ. No.

Mr. SCOTT. Can you tell me why you do not do that?

Ms. MATZ. I make it my business to go out and meet with the people who run the credit unions and have significant dialogues with them on any issue that they would like to discuss. When we had budget hearings in the past, we were just hearing from the trade associations, from one representative from each trade association. We were not hearing from the people who have their funds in the credit unions or really from the people who run the credit unions.

Mr. SCOTT. Do you think that is a very good way of holding yourself accountable to these stakeholders? Do you think that it could be improved if you did have public hearings, where the people who are paying the freight would have an opportunity to interact with you and you have an opportunity to satisfy any concerns that they may have about your budget which they are paying for?

Ms. MATZ. When you say “they” are paying for, I assume you mean the credit unions. And I would take exception to that. Credit unions are cooperatives that are owned by their members. They can only raise capital through retained earnings.

Mr. SCOTT. But, ma’am, you just agreed with me that the credit unions’ fees provide your budget.

Ms. MATZ. Yes. But it is not their money. We assess the credit unions. But it is the members who own the credit unions. And it is the members’ funds. And if we don’t have adequate resources, we can’t protect those funds.

Mr. SCOTT. Okay. Well, the members are the credit unions, and the credit unions are the members.

Ms. MATZ. No. That is not true.

Mr. SCOTT. And the members come from them.

Ms. MATZ. I disagree with that.

Mr. SCOTT. What do you disagree with?

Ms. MATZ. I don’t believe that the credit unions necessarily represent the members. And if they did, they wouldn’t be asking us to cut our budget because I think the members would like us to protect their life savings and would like us to have the resources that we need to do that adequately.

Mr. SCOTT. That is why I think it would help you and help with the transparency if you did have hearings. The record is clear. I don’t see how you could have such a negative attitude toward the very people who, through their fees, are paying your salaries, your operating expenses.

Let me go on. I have another question here. Is it true that you have a secure room, in quotes, “a secure room” at your headquarters?

Ms. MATZ. Yes.

Mr. SCOTT. What is the purpose of this room?

Ms. MATZ. It is a sensitive compartmentalized information facility, known as an SCIF. And we are required to have it by Executive Order so that we can communicate sensitive information.

Mr. SCOTT. And how often is this room used?

Ms. MATZ. There is somebody there every day monitoring it.

Mr. SCOTT. And how much did it cost to create this room?

Ms. MATZ. It cost over a million dollars. I don’t know exactly how much.

Mr. SCOTT. And did you do a cost-benefit analysis before to determine what the cost and benefits were?

Ms. MATZ. We knew what the cost was going in, and we knew we were complying with an Executive Order and that we can’t receive or disseminate classified information without it. We can’t do our job without it.

Mr. SCOTT. Without this—

Ms. MATZ. Correct. In this—

Mr. SCOTT. Why do you say you can’t do your job without it?

Ms. MATZ. Because if there is classified information to be transmitted, we wouldn’t be able to either transmit or receive it. We would have to go to somebody else’s facility. In other words, before we had it, we would have to go to the Treasury Department, for instance, in order to be part of the classified discussion, in order to receive the information. And so now, just like all of the other Federal financial regulators, we have that facility on the premises.

Mr. SCOTT. Okay. I think, from what I have heard you say, that it would not be a bad idea for you to consider—I think it would help with the relationship building with your credit unions. They play a vital role in what you are doing. And it is very important for transparency. So I think from your testimony here, it shows that there is a need for you to consider having public hearings for those who are paying the freight.

Chairman NEUGEBAUER. The time of the gentleman has expired. I now recognize the gentleman from Florida, Mr. Posey, for 5 minutes.

I will say to the Members, I am going to try to strictly adhere to the 5-minute rule. We are going to have votes here in a little bit. And I would like to get as many Members in as possible before that. We do plan, if Members intend to continue with the hearing, to come back after votes. But we would like to get through as many as we can.

Mr. Posey, you are recognized for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman.

Madam Chair, the NCUA has said that a limited number of credit unions would be downgraded if the risk-based capital proposal was in place today. I am interested in what impact this proposal would have had if it had been in place at the height of the fiscal crisis in 2009. Has the agency prepared or seen any analysis of how many credit unions would have been downgraded during the crisis? And of those that would have been downgraded under the proposal, how are they doing today without the proposal having been in place at the time? Do you kind of follow that question?

Ms. MATZ. I think I do.

Mr. POSEY. Okay. Did they all go away? Or are most of them doing fine today?

Ms. MATZ. Our analysis is that if we had that risk-based capital proposal in effect prior to the crisis, we wouldn't have lost all of the credit unions that we lost during the crisis. I don't have the exact number with me, but I can get it for you.

Mr. POSEY. Yes.

Ms. MATZ. Is that what you were asking?

Mr. POSEY. Yes. I have some credit union data which indicated that had the proposal been in place during the financial crisis, it is estimated that only 45 credit unions would have been downgraded. And of those, 41 would be well-capitalized today. The point is, that is the pain this proposal will cause all credit unions worth the gain of regulating a few bad actors that NCUA could have already reined in through the normal exam process?

Ms. MATZ. Back-testing has shown that had we had that in place, it would have caught a large number of those 102 failed credit unions, in fact. First of all, we are required by statute to have a risk-based capital rule comparable to the other financial regulators. And so, this is meeting our statutory responsibility. But we have modified the rule. We feel that it is important to have a forward-looking indicator. So it was not intended to really catch credit unions now. It was intended to get them to start planning so that they monitor the risks in their portfolios and have sufficient capital to cover those risks going forward.

Mr. POSEY. Okay. The Risk-Based Capital Study Act was recently introduced in the House to require the NCUA to examine certain issues with respect to this proposed rule. Under the legislation, the NCUA would not be able to move forward on the proposal until after this study is completed. Given that the second risk-based capital proposal received an even higher number of comments than the first, has there been any discussion at the agency to slow down the process here and, perhaps, study the issue further before proceeding ahead with the final rulemaking completion?

Ms. MATZ. Thank you. We studied the issues exhaustively between the first and second proposal, which is why it was almost completely rewritten in response to the comments we got from Members of Congress and from the credit unions. So, I don't intend to delay it. We are reviewing the comments that we have gotten. And the ones that are substantive, and we are responding to, are mostly positive. There were a lot of form letters, mostly form letters, and most of them simply stated: Don't pass another risk-based capital rule. We do have a statutory responsibility to go forward.

Mr. POSEY. My thought was that if it took 12 months last time to come up with a new proposal, shouldn't we kind of be giving it the same amount of time and effort to review the current one just to make sure we get it right?

Ms. MATZ. I feel like we have gotten it right.

Mr. POSEY. Many more comments to respond to and a whole lot more input.

Ms. MATZ. The comments are mostly form letters saying we don't need a risk-based capital rule. So they really weren't very constructive or prescriptive. But we have studied it. I don't know what more we can study. We have studied it in-depth. And we feel that this is a very fair rule that will not immediately impact more than about 20 credit unions which can either raise more capital or shift some of the risk out of their portfolios. For the rest of the credit unions, it actually adds to their capital or net worth.

Mr. POSEY. How many do you regulate? So we are saying 20 out of how many?

Chairman NEUGEBAUER. I'm sorry, the gentleman's time has expired.

Ms. MATZ. 6,100.

Chairman NEUGEBAUER. I now recognize the gentlewoman from New York, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. Thank you very much.

Chair Matz, I speak to my credit unions all the time. And, quite frankly, they have never raised transparency of the budget. Is this a really big issue with the credit unions, the NCUA?

Ms. MATZ. I have heard a lot from the trade associations about it. But when I go out and talk to the credit unions, up until now I really have not heard about it at all.

Mrs. MALONEY. Okay. Despite the very significant and substantial revisions to your risk-based capital rule, the credit union industry continues to express concerns that some of the risk weights assigned to credit unions will unnecessarily require them to hold additional capital and will ultimately restrain their ability to lend as much as they would like. So my question is, how do the risk weights under your revised proposal for credit unions compare to similar risk weights for banks?

Ms. MATZ. Thank you. Many of the risk weights that we have are comparable to banks. In fact, about 75 or 80 percent of the assets in credit unions would be weighted exactly the same as they are for banks. And I think another 15 or so percent would actually be weighted less than they are for banks. So we are pretty comparable to how the banks are risk-weighted.

Mrs. MALONEY. Do you think credit unions should be the same as banks?

Ms. MATZ. We have exempted credit unions that are under $100 million because they are not complex. But for the complex credit unions, yes, I do.

Mrs. MALONEY. Okay. And I have heard a whole disparity of opinions on your third-party vendor proposal. The GAO and the FSOC support your position for enhanced authority. But the credit unions make the argument that it is not necessary and would lead to increases in regulatory burden in your budget. Can you tell me, what are gaps in your regulatory authority, and whether it would increase your budget?

Ms. MATZ. If there is one thing that keeps me up at night, it is the cyber threat, and our lack of vendor authority. We are the only financial banking regulator that does not have vendor authority. It really ties our hands in being able to make sure that the system is secure. So we are requesting the legislative authority because if we see a red flag, we need to be able to go in and examine, supervise that third party, and, if there is a problem, to get them to correct it, and to let credit unions know about it. We simply don't have that authority now.

Mrs. MALONEY. Okay. That is a consideration.

I am also aware of legislation that is pending that would require NCUA to hold budget hearings before your budget has actually come out. But I understand that you are a peer leader in transparency. Can you describe the information you make available?

Ms. MATZ. We have a budget resource page on our website which has very extensive information. I don't know any other financial institutions regulator that provides any budget information on their website or at least it might be minimal. But we provide very extensive information on our website. I believe we are more transparent than any other Federal financial institutions regulator in terms of our budget.

Mrs. MALONEY. And can you explain how your supplemental capital proposal could work with the revised risk-based capital rule when finally implemented?

Ms. MATZ. NCUA has the authority to permit credit unions to raise supplemental capital, but only for the purposes of their risk-based capital ratio. And that is not included in our risk-based capital proposal. So at the time that we finalize it, we intend to put out a proposed rule which would permit credit unions to raise supplemental capital for the purposes of their risk-based capital ratio.

Mrs. MALONEY. And, finally, in your written statement you mentioned your support for H.R. 1188, bipartisan legislation that would permit more small business lending by credit unions. Can you describe how that would help credit unions across the country?

Ms. MATZ. Credit unions now operate under a statutory cap, which I feel is very arbitrary.

Mrs. MALONEY. What is the cap?

Ms. MATZ. The cap is 1.75 times net worth, required to be well-capitalized. And so, as a regulator, I would like to see credit unions diversify their portfolios. I think business lending is an important part of that portfolio.

Mrs. MALONEY. My time has expired. Thank you.

Chairman NEUGEBAUER. I thank the gentlewoman.

I now recognize the gentleman from Missouri, Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Madam Chair, last year, the day before this committee scheduled a markup on H.R. 4042, which is my legislation to require a stop and study of MSAs, you sent a letter asking that, and I quote, “the House Financial Services Committee refrain from considering amendments to tomorrow’s markup related to NCUA’s risk-based capital rule.”

I have never received a letter from an Executive Branch agency asking me not to do my job, which is to legislate. Can you please explain?

Ms. MATZ. I just felt as a regulator, that it was important for the safety and soundness of the system. And I was concerned about it.

Mr. LUETKEMEYER. Let’s figure out first here the responsibilities of each branch of government. My understanding is that the responsibility of the Legislative Branch is to propose legislation. And in each bill we pass, there is a clause that always says that the Executive Branch and the departments that pertain to whatever the legislation is about have the ability to implement and promulgate rules that will implement the law. And so I don’t know where the Executive Branch has the authority or the reason to tell us what to do.

Ms. MATZ. I wasn’t telling you what to do. I was just—

Mr. LUETKEMEYER. Madam Chair, you asked that the House refrain from considering amendments. You were telling us not to do any amendments to the capital-based rule.

Ms. MATZ. I was telling you to, yes, as a consideration so that I could do my job and protect the safety and soundness of the system.

Mr. LUETKEMEYER. My point is that the Executive Branch should carry out the wishes of the Legislative Branch.

Ms. MATZ. Absolutely.

Mr. LUETKEMEYER. And this is the problem with this entire Administration. Right now, the Legislative Branch is being compromised because they believe the Executive Branch can go out through Executive Order and through bureaucratic fiat create law. That is not the way the Founders designed these three branches, coequal branches, by the way, of government. This is not what they intended for the Executive Branch to do. And, quite frankly, I hope from now on you will refrain from telling us what to do.

Also, I am kind of curious, you came up with a risk-weighted rule. I was wondering if you did any sort of study to evaluate with regards to MSAs their performance during the financial crisis?

Ms. MATZ. I believe that we did, yes. I don't have the information handy.

Mr. LUETKEMEYER. Okay. One of the things that I am working on is with regards to SIFI designations, both for banks and nonbanks. NCUA sits on FSOC, is that not correct?

Ms. MATZ. Correct.

Mr. LUETKEMEYER. Can you explain to me how you could vote for designating four nonbanks, three insurance companies and another industry, as SIFIs?

Ms. MATZ. Yes.

Mr. LUETKEMEYER. What criteria did you use?

Ms. MATZ. We used the criteria that was set out in the Dodd-Frank Act.

Mr. LUETKEMEYER. What did you use?

Ms. MATZ. The criteria that were set out based on their size, interconnectedness, their leverage.

Mr. LUETKEMEYER. Okay. How big is the biggest credit union?

Ms. MATZ. About $65 billion.

Mr. LUETKEMEYER. Is it a SIFI?

Ms. MATZ. Not within the financial system, but certainly within the credit union system. What I am saying is that it is systemically important to our fund in the credit union system. But it would not be considered systemically important to the entire financial services system.

Mr. LUETKEMEYER. Right now, there is a threshold of $50 billion. Anybody above that has to comply with the stress tests and all sorts of other rules and regulations. Does this credit union comply with that?

Ms. MATZ. Yes.

Mr. LUETKEMEYER. Okay. Are you considering designated—would you support designated as a SIFI then? Is it interconnected enough?

Ms. MATZ. The financial institutions that have prudential regulators are not considered as SIFIs under the FSOC designations. Those are for nonbank institutions.

Mr. LUETKEMEYER. I only have 30 seconds left. I have one more question I want to get to before we run out of time, with regard to designating these insurance companies as SIFIs. I was in the insurance business for 30 years. I have no idea how you can tell me that one insurance company, if it goes down, destroys the entire economy. Can you give me an example of how this works?

Ms. MATZ. We look at mainly their leverage, their interconnectedness.

Mr. LUETKEMEYER. On FSOC, Mr. Woodall is one of the members, and he represents the insurance industry, and he voted against that.

Ms. MATZ. That is right.

Mr. LUETKEMEYER. Why would you vote against him, somebody who actually knows the industry and represents them?

Ms. MATZ. I think that is why the Act was written the way it was, where it brings diversity, and we bring our individual perspectives. And we get briefed by the staff. We get information from the entity. And then we each make up our respective minds.

Chairman NEUGEBAUER. The gentleman's time has expired.

Mr. LUETKEMEYER. So you are going to ignore the one person who has best knowledge of the industry.

Thank you.

Chairman NEUGEBAUER. I now recognize the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

Chair Matz, I would like to kind up pick up on that. In 2014, and again on July 20, 2015, the former chairman of this committee, Barney Frank, an author of the Dodd-Frank bill, stated that he did not believe that asset managers should be regulated as SIFIs. Would you state your perspective then on why you believe that they should be?

Ms. MATZ. Asset managers? We are now looking at the asset manager activities rather than designating specific asset managers—

Mr. PITTENGER. Do you believe they are systemically risky?

Ms. Matz. Pardon me?

Mr. PITTENGER. Do you believe that asset managers are systemically risky? And if so, how?

Ms. MATZ. We are looking at the activities that they perform. And there might be activities that are systematically risky. But we have not finished that analysis at this point.

Mr. PITTENGER. Can you name any specific asset managers that you believe are of concern to you as chairman of NCUA?

Ms. MATZ. We are looking at all the asset managers.

Mr. PITTENGER. But you can't?

Ms. MATZ. I would rather not. We are looking at all the asset managers. We are not, I am one member—

Mr. PITTENGER. Systemic risk—

Ms. MATZ. Pardon?

Mr. PITTENGER. —to the financial system in this country. Can you name any?

Ms. MATZ. We are not designating asset managers. We are looking at the activities of asset managers. And until I am briefed on it, I don't have an opinion.

Mr. PITTENGER. We received testimony, this committee did, that the SIFI designation for asset managers would result in $100,000 in cost to each investor. Are you aware of that?

Ms. MATZ. No. But we are not designating asset managers now. We are looking at the activities of the asset managers. And that is a long way off. We are only beginning to have those studies done.

Mr. PITTENGER. But that is where you are probing. That is what is on your radar screen. Do you believe that any action taken by FSOC to designate asset managers and their activities systemically important would be consistent with the congressional intent of Dodd-Frank?

Ms. MATZ. I think if we finally got to the designation, we wouldn't make that designation unless we believed that. And I certainly wouldn't support it unless I believed that.

Mr. PITTENGER. Chair Matz, what do you understand is the business of an asset manager? Would you explain to me their business?

Ms. MATZ. It is managing the assets of individuals.

Mr. PITTENGER. All right. They have the obligation to their clients to invest, is that right?

Ms. MATZ. Correct.

Mr. PITTENGER. And these are owned by the clients, they are third-party custodians?

Ms. MATZ. Yes.

Mr. PITTENGER. They have contractual obligations. They are advisers, and they are agents, aren't they?

Ms. MATZ. They are—

Mr. PITTENGER. They are advisors, and they are agents on behalf of their clients. Is that correct?

Ms. MATZ. Yes.

Mr. PITTENGER. I think it is important to note that these managers don't also employ the balance sheet leverage. Is that correct?

Ms. MATZ. To the best of my knowledge, it is.

Mr. PITTENGER. Thank you. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from New Hampshire, Mr. Guinta, is recognized for 5 minutes.

Mr. GUINTA. Thank you very much, Mr. Chairman.

Chair Matz, as I stated in my opening statement, financial institutions across the Nation are merging or consolidating at what I would consider a pretty alarming rate. And that concerns me because, to me, that represents less access to credit for a whole host of individuals for a whole host of needs that families, average families require. There were 12,891 credit unions back in 1990. And today, I believe we have about 6,200, according to the first quarter data that you put out. So would you talk to me a little bit about, over the last 25 years, why there were so many consolidations and if you think—what, if any, portions of Dodd-Frank would have something to do with that? Or if you don't think Dodd-Frank had anything to do with that, I would like to know that as well.

Ms. MATZ. We provided some slides. Just in reference to that last question, slide 1 shows the decline in federally-insured credit unions since 1990. And you can see the trajectory started in the early 1990s and has just continued after Dodd-Frank. It did not start with Dodd-Frank. So, personally, I don't think Dodd-Frank was related to credit union failures. But it is a sad story. And it is one that has been very frustrating to me because we lose about 250 credit unions a year. And that has been consistent for the past 20 years. It is a result, I think, of not being able to achieve economies of scale, of not being competitive in the marketplace. Frequently a manager who has been running the credit union for 25 years decides to retire, and there is no succession plan. And the Board realizes that their members could probably be better served by merging. So, the vast majority are voluntary mergers.

We have an Office of Small Credit Union Initiatives, which I helped to create when I was on the Board last time, which works with small credit unions and provides free consulting services for them. And they have helped about 600 credit unions grow from the definition of small to large. So, in that number there, that includes some credit unions, I believe—I might be wrong—but there are about 600 credit unions that aren't considered small anymore because now they are over the limit.

But it is a source of frustration because small credit unions frequently are located in areas where there are no other insured financial service institutions. And so we really try to work hard and do a lot of hand-holding and we have exempted small credit unions from a number of our regs so that we can—where we can—mitigate the regulatory burden on them.

Mr. GUINTA. So because of the trajectory before Dodd-Frank, you are saying, Dodd-Frank, because of the losses post and pre are essentially similar or identical, you are saying Dodd-Frank has nothing to do with it?

Ms. MATZ. I haven't seen any evidence of it.

Mr. GUINTA. Okay.

When I talk to bankers who are running credit unions in New Hampshire, they talk to me about the regulatory burden, the compliance requirements. Anywhere from 10 to 30 percent of their time is now focused on regulatory. So I couldn't speak to pre-Dodd-Frank. But I can tell you that post-Dodd-Frank, that is the single largest concern expressed to me by credit union executives. If that is what they are telling me, and they are on the ground, it is not consistent with your opinion relative to Dodd-Frank.

Ms. MATZ. I just haven't seen evidence of it. I know that there is a burden on small credit unions. There is a burden on all credit unions. Small credit unions have a very difficult time dealing with the regulatory burden, but it is the regulatory burden in general. It is not necessarily NCUA.

The one I hear most about is BSA. They have a great deal of difficulty complying with BSA. So if I had to pick one, that would be the one that I hear most about.

But I just can't answer that. I just don't know, but it is very frustrating to me that we are losing so many small credit unions. And we work hard to meet with them and to see if there are ways that we can change our policies so that we can help them out.

Mr. GUINTA. In New Hampshire, we have about 1.3 million people, so we are very community-based. So I understand the concerns or the items that you ticked off, economies of scale. I disagree with that, because in New Hampshire we tend to go look to our local community bank or credit union for help. But I would invite you to come to New Hampshire with me, and meet some of these credit union execs because I would love to—

Ms. MATZ. I would welcome the opportunity to do that.

Chairman NEUGEBAUER. The gentleman's time has expired.

Ms. MATZ. I would like to do that.

Mr. GUINTA. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I will now go to the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman.

And thank you, Chair Matz, for being here. In NCUA's 2014 annual report, it is noted that 17 of its 15 credit union failures occurred because of instances of fraud and ended up costing the Share Insurance Fund $36.5 million as well as, in October 2014, at the NCUA Board meeting, your CFO Mary Woodson stated that 94 percent of the losses to the Share Insurance Fund were related to fraud. Are these fraudulent-related losses to the Share Insurance Fund, are those of concern to you?

Ms. MATZ. They are a concern on the one hand because it is fraud. But in terms of the impact on the Share Insurance Fund, it is a minimal impact. But, yes, unfortunately, mostly the fraud occurs in small credit unions because they tend not to have internal controls or have very few internal controls. So—

Mr. TIPTON. And that is part of your oversight—

Ms. MATZ. It is.

Mr. TIPTON. It is. And perhaps a little follow-up on my colleague Mr. Guinta's comments with regard to the regulatory process. You discussed several NCUA priorities and initiatives, including a proposed rule on risk-based capital for credit unions, vendor examination authority, and stress testing for credit unions. If the NCUA is unable to prevent $36.5 million in losses to the Share Insurance Fund this last year, is it really going to be capable of handling expanded regulatory authority?

Ms. MATZ. I believe we are, yes. The fraud—

Mr. TIPTON. How many more people will you have to add?

Ms. MATZ. None. We are not planning to add any more people. We are reallocating resources, but we don't intend to add any. We intend to train people differently, but we are not planning to add any more.

Mr. TIPTON. Do you own any responsibility on that? because you said that part of this failure was regulatory in nature. What are you doing to address that?

Ms. MATZ. The fraud failure?

Mr. TIPTON. Yes. You didn't identify it.

Ms. MATZ. We have given our examiners more training on dealing with fraud, and we have provided certifications for a number of examiners, fraud certification.

Mr. TIPTON. Is all of that training completed now?

Ms. MATZ. It is ongoing.

Mr. TIPTON. It is going to be ongoing. Chair Matz, in 2014 the NCUA issued a final rule that was going to require the submission of capital planning proposals and stress testing for credit unions with assets greater that be $10 billion. The rule applies to five credit unions that already conduct their own stress testing.

What was inadequate about the internal stress test that spurred the NCUA into creating a stress-testing rule that is not required by Dodd-Frank?

Ms. MATZ. We couldn't validate the individual stress testing that they are doing, and so we weren't. They are our largest credit unions and they certainly pose, each individually and certainly as a group, a large risk to the Share Insurance Fund. We needed to make sure that they are holding sufficient capital, and so we are doing the stress tests now. But after 3 years, when we have a record and know how they operate, they can apply to us to then just do their own stress testing.

Mr. TIPTON. You just used the words, "We couldn't verify the veracity of their stress tests. We couldn't monitor it." Do you do the stress testing through the NCUA?

Ms. MATZ. No. We contract that work out.

Mr. TIPTON. So it is not you at all. You don't have the expertise to be able to do this?

Ms. MATZ. No, that is correct. That is correct.

Mr. TIPTON. That is correct. So what do you pay for that?

Ms. MATZ. For the contract? It is $4 million.

Mr. TIPTON. $4 million, and that is in your budget, I assume.

One other question I would like to be able to address is the expansive powers that we are seeing out of Dodd-Frank, FSB, FSOC, organizations that you are affiliated with, obviously, in terms of the broadening regulatory net. We see General Electric now trying to be able to dispose of assets in order to not be classified as a SIFI. That is going forward.

Chair Matz, as a member of the FSOC, are you willing to be able to give some kind of a roadmap so that these businesses are not just shooting in the dark as to whether or not they are going to be designated? Because from what I am hearing from you and from other representatives of the Administration, once we put one marker down, we are then going to go after shadow banking, which will require more regulation, which will require more Administration. So are you willing to give a roadmap so the businesses know what to be able to do?

Ms. MATZ. I think that is very important, yes.

Chairman NEUGEBAUER. The time of the gentleman has expired.

Mr. TIPTON. Thank you.

Chairman NEUGEBAUER. The gentleman from Texas, Mr. Williams, is recognized for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman.

And thank you, Chair Matz, for being here today. Chair Matz, we have become aware of an NCUA policy of awarding on-the-spot bonuses and cash awards to employees, cash bonuses of up to $2,500 that can be paid to employees twice a year, and they get these for services going above and beyond the call of duty. We have heard that the NCUA's HR department bragged, actually bragged about paying over $1.2 million in these bonuses in 2014, frankly, for just doing your job.

Now, from what I can see, there appears to be little to no control over these payments. Any manager can give a cash award to anyone with as little as a one-paragraph justification. We are told that this program has become commonplace within the agency. So my first question is, who approves these bonuses, and what policies and controls are in place to manage the distribution of these cash rewards?

Ms. MATZ. For the smaller ones, the $250 on-the-spot awards, it is the first-level supervisor. They can only give a certain budgeted amount each year. So, that is somewhat prescribed. They can't just keep giving them. They only have a certain number that they can give. The larger it is, the more signoffs they need on it.

Mr. WILLIAMS. Have you personally awarded such bonuses to your staff?

Ms. MATZ. Yes.

Mr. WILLIAMS. To whom and in what amounts?

Ms. MATZ. That is a good question. I believe I—

Mr. WILLIAMS. It is only money.

Ms. MATZ. I believe I awarded $2,500 to my chief of staff, who had not received a pay raise in 5 years.

Mr. WILLIAMS. A lot like the private sector.

Ms. MATZ. I'm sorry?

Mr. WILLIAMS. Much like the private sector that hadn't received any pay raises.

Ms. MATZ. And I provided a cash award to my administrative assistant, and I believe that was either $1,000 or $1,500.

Mr. WILLIAMS. When was the last time you awarded one of these bonuses?

Ms. MATZ. It was probably a year ago.

Mr. WILLIAMS. Okay. Now, how about in 2015? How many on-the-spot bonuses or cash awards has NCUA given out?

Ms. MATZ. I don't know, but it is on our internal website. We post it so our employees are aware of who is getting awards.

Mr. WILLIAMS. But you are not sure how many went out?

Ms. MATZ. I don't know. As I said, we have a total amount, a prescribed amount, beyond which the agency can't go.

Mr. WILLIAMS. Okay, now correct me if I am wrong, but this is money that the credit unions give to you through fees.

Ms. MATZ. I'm sorry.

Mr. WILLIAMS. This is money that the credit union gives to you in fees?

Ms. MATZ. Correct.

Mr. WILLIAMS. Okay, and for the purpose of supervision to ensure safety and soundness?

Ms. MATZ. Correct.

Mr. WILLIAMS. But I bet some of these credit unions would actually love to be lending out the money to their customers rather than having some bureaucrat in Washington get a bonus for just doing her job. So what would you say to the credit unions that I have back in my district? I have quite a few. What would you say to the credit union community about these bonuses?

Ms. MATZ. I would say that they are bonuses to people who work very hard to protect the safety and soundness of the deposits that members have in their credit union, and that when people go above and beyond, they deserve to be recognized so that we can retain our talented employees.

Mr. WILLIAMS. And you think the credit unions would agree with you as opposed to having that money to loan out to small business owners like me?

Ms. MATZ. I have no idea.

Mr. WILLIAMS. It might be a question you want to ask them the next time you meet with them.

Ms. MATZ. I am sure they give bonuses to their employees as well, using their members' money.

Mr. WILLIAMS. Finally, since this hearing is focused on transparency, would you provide this committee with a complete list of employees who have received these bonuses in 2014 and 2015, so that we can shed some light on the policy and learn more how it works?

Ms. MATZ. Sure.

Mr. WILLIAMS. Would you do that for us?

Ms. MATZ. Absolutely.

Mr. WILLIAMS. I would appreciate it.

Mr. Chairman, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Kentucky, Mr. Barr, is recognized for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

Chair Matz, I want to continue along the lines of questioning from Mr. Williams over here regarding not just bonuses but some of the, what I would consider irregularities, in the NCUA's 2015 budget.

In the Office of Consumer Protection, pay and benefits for 2015 are $7.3 million, up 9 percent, I believe, or equal to $600,000, yet the office has only added 2 people. What accounts for this large budget increase?

Ms. MATZ. I would have to get back to you on that, sir.

Mr. BARR. Okay, if you could, that would be great.

And given the fact that the Consumer Financial Protection Bureau has now been with us for 4-plus years, how is this Office not duplicative of the mission of the Bureau?

Ms. MATZ. It deals with the fact that the CFPB examines financial institutions over $10 billion. Our Office of Consumer Protection does fair lending exams on credit unions of all other sizes, which we are required to do by law.

Mr. BARR. But, obviously, the Bureau has—the Bureau's policies impact credit unions that have less assets than $10 billion. Do you agree?

Ms. MATZ. They impact them, sure.

Mr. BARR. Sure. And so my question is, why is an Office of Consumer Protection necessary within your agency?

Ms. MATZ. As I said, they do exams, fair lending exams, which the CFPB doesn't do. They also respond to consumer complaints about their credit unions because CFPB only handles complaints on institutions above $10 billion.

Mr. BARR. How about the Office of Small Credit Union Initiatives? Your annual report says that half of all small credit unions shrank in 2014 with an average return on assets of just 4 basis points. Obviously, these institutions are struggling. Yet, your budget cuts the programming budget to offset a 5-percent pay increase for office staff, the overall budget is unchanged, so this appears to be a pure shift from programming to employee pay. Am I misinterpreting that, or is that accurate?

Ms. MATZ. I don't know. I would have to go back and look at it.

Mr. BARR. Okay. I think the credit unions would appreciate you looking at that because it may not be the right message to send, particularly to struggling credit unions.

Ms. MATZ. And I would be happy to come up and discuss this with you once I get briefed on it and understand it myself.

Mr. BARR. Thank you. One other question on this, on the 2015 budget, for the Office of Human Resources, why does the NCUA need 44 human resources staff to service fewer than 1,300 employees? By my calculation, that HR-to-staff ratio is 1 to 30, which is 3 times higher than the average for a large company. So why such a robust HR division?

Ms. MATZ. We have 9 percent turnover, so they are constantly putting out vacancy announcements, arranging interviews, doing outreach, handling all of our benefits. I can't—

Mr. BARR. And yet.

Ms. MATZ. I can't defend the exact number, but I am just telling you what they do.

Mr. BARR. Okay. No, I hear that, and yet also the HR office is spending $3 million on contracted services. So you have a very large staff plus you are contracting out.

Ms. MATZ. They also handle all of the training for our examiners, so that is part of their budget. And the contracting also includes the hotels that they use for the training.

Mr. BARR. Okay, let me shift really quickly to, again, this idea of the conflicting missions of the NCUA and the CFPB, and I will just take an example on payday lending. On page 24 of NCUA's annual report, that report mentions NCUA's effective payday alternative loans rule, under which Federal credit unions may charge up to 28 percent on short-term loans meeting certain conditions. The Bureau has proposed its own payday proposals that are widely expected to prohibit credit unions to continue to offer the product that your rules specifically permit. Can you address this apparent contradiction?

Ms. MATZ. I have, and the parameters of our rule are exempted from the CFPB rule. They didn't exempt our rules explicitly, but they wrote it so that our—

Mr. BARR. I understand the way it is written, and I understand—but as a matter of policy, okay, this is the policy of the government, on the one hand. One agency, the Bureau, accuses these providers of short-term credit as predatory on the one hand, and yet, you are offering the same products?

Ms. MATZ. No.

Mr. BARR. —or permitting the same product, rather?

Ms. MATZ. No. Our product is an alternative because it can only be a maximum of—

Mr. BARR. I don't believe it is necessary—I am not saying it is predatory. I am just saying there is a conflict in how the Federal Government is treating these products.

Ms. MATZ. They are looking at the predatory loans, which are maybe 300 percent, and the credit union loans have a maximum APR of 28 percent. So we provide guidance so that credit unions can make those loans in a way that competes with the more expensive loans, but is much more reasonable for their members.

Chairman NEUGEBAUER. The time of the gentleman has expired.

Mr. BARR. I thank the chairman, and I yield back.

Chairman NEUGEBAUER. I ask unanimous consent that the gentleman from California, Mr. Royce, a member of the full Financial Services Committee, be allowed to join the panel and ask questions.

Without objection, Mr. Royce is recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

And thank you very much, Chair Matz, for being with us today. It is good to see you. I want to thank the NCUA for its recent efforts in working to provide regulatory relief to credit unions that are sound, and safe, and stable. And I think doing so will be beneficial not only to the credit union members, but also to the American economy. I also appreciate your testimony today in support of legislation that Mr. Meeks and I have crafted to provide relief to credit unions from the member business lending cap. As you expressed, particularly for smaller credit unions, the current statutory cap makes it very difficult or impossible for credit unions to successfully support the small business community.

While your testimony specifically cites your support for this bill, H.R. 1188, the Credit Union Small Business Cap Jobs Creation Act, I also want to get your thoughts on H.R. 1422, the Credit Union Residential Loan Parity Act. As you know, this bipartisan bill would correct the disparity between banks and credit unions in the treatment of loans made to finance the purchase of one-to-four-unit non-owner-occupied residential dwellings. I see this as a simple straightforward fix, especially when you consider the potential positive impact in helping finance investment in multi-family and affordable housing.

So I was going to ask you, Chair Matz, in this legislation, would the NCUA support this, and do you see a difference between one-to-four-unit loans and commercial business loans?

Ms. MATZ. Thank you, yes. And thank you also for your sponsoring the IOLTA Parity bill. Yes, we certainly support that legislation, and in fact, in the risk-based capital rule, we treat the one to four residential units as consumer loans rather than business loans. But that is as far as we can go because of the statute. So, we would welcome that relief.

Mr. ROYCE. I appreciate your support for that. I also encourage other members of the committee to join me in supporting this bill because it would unlock about $11 billion in credit union lending for small business. That is important.

On another front, as you indicated in your testimony, improving the field of membership rule is a priority for the NCUA. You have even set up a separate working group to address regulatory relief needs on this front. I know the NCUA has a proposed rule addressing proposed streamlined field of membership procedures and is working to address issues related to community charters and occupation charters. And my question is, while much of this work could be left to the NCUA alone, is there anything Congress should be doing to address the field of membership issues in the statute?

Ms. MATZ. Thank you for asking that. Yes, there are several things that can be done, but probably the most impact would occur if community charters would be allowed to take on underserved areas. That would help keep the Federal charter competitive and would provide relief to a number of community charters, which really would like to take on underserved areas, but can't do it. And it really makes no sense. I can't figure out any reason for it. And we hate to say no, but we have no choice.

Mr. ROYCE. Thank you, Chair Matz, very much, for your testimony here today.

And, Mr. Chairman, I will yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentleman, and now the gentleman from Pennsylvania, Mr. Fitzpatrick, is recognized for 5 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I would like to yield my time to Mr. Mulvaney of South Carolina.

Mr. MULVANEY. I thank the gentleman. Chair Matz, thank you for the second round of questions, and the opportunity to follow up on a couple of things you said earlier. You may have seen many of us on the dais react in a stunned fashion when you said something that I can't actually believe that you said. You said you don't believe that the credit unions represent their members.

Ms. MATZ. Yes.

Mr. MULVANEY. You are nodding your head "yes" as if that was actually what you said. So who do the credit unions represent?

Ms. MATZ. The credit unions in asking for budget hearings and telling us that we need to cut our budget and cut our exam hours are not representing the best interest of their members.

Mr. MULVANEY. I got you. When they ask to cut the budget, whose money are they trying to save? It is their members', isn't it?

Ms. MATZ. Yes, it is.

Mr. MULVANEY. Isn't that exactly what you would expect them to do, try and protect their members' money?

Ms. MATZ. No, I would expect them to want to have—

Mr. MULVANEY. You wouldn't expect them to protect their members' money?

Ms. MATZ. Not in that way. That is not protecting the members' money, sir.

Mr. MULVANEY. Okay, so tell me again who you think the credit unions represent? If they don't represent their members, who do they represent?

Ms. MATZ. Credit unions by and large haven't been asking for this. It is the trade associations.

Mr. MULVANEY. I didn't ask you that, although it is a really good answer to a question I didn't ask. So I will ask it again. If the credit unions don't represent their members, who do they represent?

Ms. MATZ. I can't answer that. You would have to ask them.

Mr. MULVANEY. You don't have any opinions about it? They represent themselves? Are they preying on their own members? Have you talked to the CFPB about this?

Ms. MATZ. Credit unions—when they ask us to cut our exam hours—are not representing the best interest of their members.

Mr. MULVANEY. I am a credit union member. Are you a credit union member?

Ms. MATZ. I am.

Mr. MULVANEY. I am a credit union member. I think they are representing me when they ask you to do that. In fact, I happen to believe that my credit union represents me fairly well. And as a member of that credit union, I like the fact that they are trying to guard my money and be fairly conservative with it.

Ms. MATZ. How are they guarding your money?

Mr. MULVANEY. You have a budget that has gone up much higher than the rate of inflation. You have a staff that is going up higher than the other regulatory bodies, but let's continue this line of reasoning.

You said, when I asked you about why you didn't like my bill, that you didn't think that input from the credit unions into your budget process, more input, would be helpful. But you also said in response to a question to another Member earlier today that you really thought that input from your own employees was helpful in that budget process.

So what I hear, as a member of a credit union, is that you don't think the input from the people who pay for you is helpful, but you do think that the input from the people that you pay is helpful. So help me reconcile what an ordinary human being would describe as self-serving crazy talk.

Ms. MATZ. I go out all the time and speak to credit union officials and board members. I have been doing this for 6 years in this term and 4 years in the last term. And I can tell you, the NCUA budget is not something that comes up. They talk about our regulations.

Mr. MULVANEY. It comes up with me.

Ms. MATZ. But it doesn't come up with me.

Mr. MULVANEY. I represent one of the most heavily credit union districts in the country. It comes up with me all the time. So you are saying they never raised with you concerns about your budget? This is something that a trade association has drummed up in order to raise dues or something like that?

Ms. MATZ. That is what I am saying.

Mr. MULVANEY. So you think that the credit unions are happy with your budget?

Ms. MATZ. I don't think the credit unions really care about—

Mr. MULVANEY. Now, wait a second. Let's go back and say that. If it is not an issue for them, then what is the harm in going through the process that is laid out in my bill? What is the harm of having meetings with them, of having them have the opportunity to go over the line-by-line budget? If they are happy with your budget, and it is just an issue that is being ginned up by a trade association, what is wrong with passing my bill?

Ms. MATZ. We are an independent regulator, and while it might have a good intention, I don't think it is good government to have the people who are regulated trying to participate in the budget-making process of the regulator, the regulator who determines how many exam hours it needs and where those hours are going.

Mr. MULVANEY. Why not?

Ms. MATZ. Because I think it is influencing, negatively influencing. When I was on the Board last time—

Mr. MULVANEY. Would you rather we just put you on a budget here? Would that solve a lot of problems, just not make the credit unions pay for you here, but have you be an appropriated regulator? Would you like that more?

Ms. MATZ. I am fine with the way it is.

Mr. MULVANEY. Well, you are. But evidently the people that you regulate aren't. So I am asking you, as opposed to having to answer to the credit unions because you don't think it is right that they have input—that is what you just said. You said you don't think it is right to have input in the budget if you are the one that is regulating them. That is fine. You don't regulate us. You can come to us and ask for money. Would you rather have Congress looking over your shoulder than the credit unions?

Ms. MATZ. An independent regulator is not answerable to the entities it regulates.

Mr. MULVANEY. Or to anybody, evidently. You are not answerable to us. It took me 18 months to get a copy of your budget. So

I will ask you one last time over the last 8 seconds: Would you rather leave it the way that it is, or would you rather come into the appropriations process and have Congress oversee you?

Ms. MATZ. I am fine the way it is.

Mr. MULVANEY. I figured you probably would be. Thank you very much.

And thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman. I would like to thank Chair Matz for appearing before the panel today.

And, without objection, I would like to submit the following statements for the record: the Independent Community Bankers of America; the American Bankers Association; the National Association of Federal Credit Unions; the Credit Union National Association; the National Association of State Credit Union Supervisors; and the Joint State Banking Trade letter.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place her responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

I would also like to recognize some folks who are working for the people in the 19th District. We have some interns who are here at the hearing today, and we are glad to have them and glad to have them up for this summer.

Without objection, this hearing is adjourned.

[Whereupon, at 3:50 p.m., the hearing was adjourned.]

A P P E N D I X

July 23, 2015

NCUA

Embargoed until Delivery
2:00 p.m.
July 23, 2015

Congressional Testimony

Debbie Matz
Chairman
National Credit Union Administration Board

House Financial Institutions and
Consumer Credit Subcommittee

Hearing on National Credit Union Administration
Operations and Budget

NCUA is the independent federal agency created by the U.S. Congress to regulate, charter, and supervise federal credit unions. With the backing of the full faith and credit of the United States, NCUA operates and manages the National Credit Union Share Insurance Fund, insuring the deposits of 100 million account holders in all federal credit unions and the overwhelming majority of state-chartered credit unions.

At MyCreditUnion.gov and Pocket Cents, NCUA also educates the public on consumer protection and financial literacy issues.

NCUA

Congressional Testimony

Chairman Neugebauer, Ranking Member Clay, and Members of the Subcommittee, the National Credit Union Administration appreciates the invitation to appear before you today. I am Debbie Matz, NCUA Board Chairman.

When I returned to the NCUA Board in August 2009, in the wake of the Great Recession, the credit union system was on the brink of collapse.[1] To prevent this, we developed an unprecedented mechanism to securitize $50 billion in toxic corporate credit union assets.

Additionally, 351 consumer credit unions holding $51.6 billion in assets were close to failing by May 2010. Compounding this situation, NCUA's budget and staffing in the years leading up to the crisis had not kept pace with credit unions' growth and increasing complexity. In fact, during the seven years leading up to the crisis, NCUA had cut a total of 91 staff positions—even though credit union assets had increased by over 70 percent. During this same period, NCUA's budget as a percentage of credit union assets declined by 35 percent. NCUA was understaffed and under-resourced.

Now, nearly six years later, we've rectified these problems for corporate credit unions and consumer credit unions.

The corporate credit union system has experienced transformational changes. A series of NCUA rules beginning in 2010 will prevent corporate credit unions from taking the level and type of risk that caused the corporate credit union crisis. Regulations now prohibit purchases of private-label mortgage-backed securities, set clear investment concentration limits according to risk, increase incentives to diversify portfolios, and require higher-quality capital.

Under a strong regulatory framework, corporate credit unions have changed their business model. After reducing reliance on investment yields, corporate credit unions now generate most earnings through transaction services and payments systems. Corporate credit unions are also gradually reducing reliance on capital contributions from member credit unions. They are instead building retained earnings.

As a result of these changes, the 12 remaining corporate credit unions are collectively stronger and pose much less risk to the Share Insurance Fund today than their predecessors did during the crisis.

[1] The term "credit union" is used throughout this testimony to refer to federally insured credit unions. As of March 31, 2015, the 6,206 federally insured credit unions represent 98 percent of all credit unions in the United States. NCUA does not oversee 128 privately insured, state-chartered credit unions.

The consumer credit union system is also once again on a strong footing. It has recovered to pre-crisis levels.

Nationally, consumer credit unions are experiencing lower delinquency and charge-off rates, as well as rising earnings and net worth. Perhaps most significantly, the percentage of assets in troubled credit unions—which peaked at 5.8 percent of assets in May 2010—has dropped to just 1 percent of assets.

This turnaround has resulted, in part, from an improving economy. Credit is also due to the CEOs, managers, and boards who made tough choices to keep their credit unions solvent, as well as NCUA staff who supervised credit unions under very difficult circumstances.

The experiences of the recent financial crisis have also informed NCUA's current budgeting decisions. Budgets cannot be aimed at consistent staff cuts, as was the case for seven consecutive years leading up to the Great Recession when the agency held budget hearings. Instead, NCUA's resources and staffing need to keep pace with the risks and complexity of the credit union system. The NCUA Board has now achieved that appropriate balance, while preventing any unnecessary budget and staffing growth.

The financial crisis also demonstrates why NCUA must maintain needed resources in positive economic cycles to prepare for downturns. As the crisis hit, NCUA quickly needed to augment our pool of examiners to address significant increases in the number of credit unions experiencing balance sheet and operational problems. However, developing fully seasoned examiners requires several years of training and experience, and there were limited talent pools from which to draw these experts. Moreover, other banking agencies were competing for this same talent as the crisis took hold.

NCUA's budget increases as a result of the crisis took place more gradually than at comparable financial institutions regulators. However, in the aggregate, the agencies' operating budgets have increased by comparable amounts since the crisis.

NCUA has also diligently worked during the last six years towards greater budget transparency. As a result, NCUA now leads financial institutions regulators in budget transparency. Our website contains a dedicated budget resource center with detailed information about the agency's spending plans, annual fund audits, and a wealth of other budget information.[2]

Credit Union System Performance and Trends

The credit union system continues to experience steady growth in members and assets. As of March 31, 2015, there were 6,206 credit unions serving 99,969,794 consumers and member businesses. Together, these credit unions hold in excess of $1.1 trillion in assets.

[2] See http://www.ncua.gov/about/Pages/budget.aspx.

System Performance Improves

The credit union system has recovered from the Great Recession and is performing well. Between the second quarter of 2009 and the first quarter of 2015, credit unions experienced improvements in earnings, asset quality, capital, and lending as follows:

- ***Earnings.*** Return on average assets for the credit union system has nearly tripled during this timeframe, rising from 0.27 percent to 0.78 percent.
- ***Asset Quality.*** Credit union asset quality has also improved. The delinquency ratio fell by more than half, decreasing from 1.60 percent to 0.69 percent.
- ***Net Worth.*** The net worth ratio for the credit union system climbed from 10.0 percent to 10.8 percent.
- ***Lending.*** Total loans at credit unions grew by $151.9 billion, more than 25 percent during this time period. Over half of the growth in credit union loans was in first mortgages.

The performance of larger and smaller credit unions, however, varies significantly. The table below provides a summary of federally insured credit unions' current ratios and growth during the first quarter of 2015 by asset size for selected metrics.[3]

Credit Union Performance by Assets, First Quarter 2015

	Above $500 million	$100 million to $500 million	$10 million to $100 million	Under $10 million
Number of Credit Unions	468	1,048	2,780	1,910
Net Worth Ratio	10.7 percent	10.8 percent	11.7 percent	14.7 percent
Net Worth Growth	▲ 8.7 percent	▲ 5.8 percent	▲ 3.1 percent	▲ 1.1 percent
Loan Growth	▲ 7.1 percent	▲ 3.2 percent	▼ 0.5 percent	▼ 5.9 percent
Membership Growth	▲ 4.6 percent	▲ 2.5 percent	▲ 0.1 percent	▼ 1.7 percent
Return on Average Assets	91 basis points	54 basis points	33 basis points	19 basis points

Source: Call Reports

As shown above, the 468 federally insured credit unions with more than $500 million in assets continued to lead in most performance measures in the first quarter of 2015. With $817.1 billion in combined assets, the largest credit unions held more than 70 percent of the system's total assets at the end of the first quarter and had a return on average assets of 91 basis points.

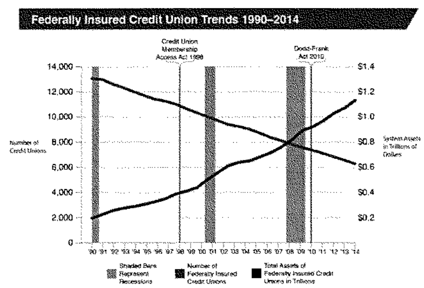
At the other end of the system, 1,910 credit unions with assets under $10 million had a return on average assets of 19 basis points. Lending by the smallest credit unions declined by almost 6 percent for the year ending in the first quarter of 2015, while rising by 7.1

[3] See page 10 of http://www.ncua.gov/Legal/Documents/Reports/FT20150331.pdf for more information about other metrics.

percent for the largest credit unions. Membership growth declined by 1.7 percent for credit unions with assets under $10 million during the first quarter of 2015, while the largest credit unions collectively grew their membership by 4.6 percent.

Consolidation Continues as Assets Grow

As a result of the challenges that smaller credit unions continue to face, long-time consolidation trends within the system continue. As the chart below shows, the pace of credit union consolidation has been steady over more than two decades and across a variety of economic cycles, including the recession of the early 1990s, the bust of the technology boom in the early 2000s, and the recent Great Recession.



The trend has remained relatively constant after the passage of landmark laws such as the Credit Union Membership Access Act of 1998 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This long-term credit union trend is very similar to the consolidation trends occurring among banks and thrifts.

Despite the steady decline in the number of credit unions during the last 25 years, the assets within the credit union system have risen substantially over the same timeframe. Overall, assets have experienced a more than five-fold increase since 1990. Credit union membership also has nearly doubled over the same time period.

Within the system, consolidation is primarily occurring among small credit unions. During the past five years, 1,308 consumer credit unions have voluntarily merged.[4] More than 90 percent of these former credit unions had assets of $50 million or less at the time of the merger, and another 6 percent held assets between $50 million and $100 million.

[4] The five years stated here cover the last quarter of 2009 through the first quarter of 2015.

Small credit union viability is being challenged by the convergence of a number of circumstances. The financial services sector is evolving rapidly, and it is difficult for less-resourced, smaller credit unions to keep pace with marketplace and regulatory developments. Additionally, small credit unions face challenges in attracting and retaining talent. Often when a long-term credit union manager of a small credit union retires, there is no successor.

Another critical factor contributing to the decline in the number of small credit unions is an inability to take advantage of economies of scale. This results in higher operating costs and weaker earnings. Lack of size and scope also makes it difficult for smaller credit unions to adopt the technological and product innovations demanded by consumers.

Today, just under half of credit unions with less than $50 million in assets provide the combined services of checking accounts, real estate loans, ATM and debit cards, and home banking services (including mobile banking), essential in today's market. In contrast, all of these services are provided by virtually all credit unions with assets greater than $50 million. These differences have persisted over the past ten years, underscoring the competitive challenges small credit unions confront.

Other factors contributing to the decline of smaller credit unions include the lack of adequate succession planning to replace key employees who retire and the inability for a single-sponsor credit union to overcome losing its sponsor. Imprudent management decisions, insufficient internal controls, and fraud also have played a role in the system's consolidation. Fraud was a contributing factor to $337 million in losses for the National Credit Union Share Insurance Fund between 2010 and 2014 at liquidated credit unions of all sizes.[5]

Support for Small Credit Unions

Together, these statistics demonstrate the continued need for NCUA to support and assist small credit unions. Through our Office of Small Credit Union Initiatives, which I worked to create in 2005 during my first term on the NCUA Board, we offer training, information on successful growth and service strategies, and support opportunities for small credit unions to partner and collaborate. Additionally, the office provides affirmative assistance to small credit unions through free consulting, such as the net worth restoration plan assistance required by the Federal Credit Union Act.[6] The office also awards grants and offers

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[5] Congress established the National Credit Union Share Insurance Fund in 1970 as part of the Federal Credit Union Act (P.L. 91-468) and amended the Share Insurance Fund's operations in 1984 (P.L. 98-369). The fund operates as a revolving fund in the U.S. Treasury under the administration of the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state-chartered credit unions that request federal insurance. Funded by federally insured credit unions, the Share Insurance Fund is backed by the full faith and credit of the United States.

[6] 12 U.S.C. 1790d(f)(2).

reduced-rate loans to low-income credit unions, many of which are small credit unions.[7] NCUA makes these grants and loans through the Community Development Revolving Loan Fund created by Congress.[8]

Last year, the Filene Research Institute, an independent research firm, analyzed the impact of NCUA programs in helping small credit unions to survive and thrive. The study included data analysis, direct feedback, and a practitioner focus group. Specifically, the firm examined our small credit union initiatives from 2009 to 2013, consisting of:

- 44,738 hours of consulting services, at no charge to the credit unions;
- $6.5 million in grants and $21.7 million in loans; and
- Training to 7,000 credit union employees and volunteers.

The study demonstrated that our Office of Small Credit Union Initiatives was particularly effective in helping credit unions with assets from $1 million to $10 million grow into larger asset categories. Assistance from NCUA empowered many of these smallest credit unions to offer new services, leverage new technology, and market to new membership groups.

The study found discernable effects from our efforts. Based on these insights, we further sharpened our focus. Starting in 2015, we switched entirely from onsite training to digital formats including videos, webinars, white papers, and an e-newsletter. Participation in our small credit union initiatives has increased more than tenfold.

Looking forward, we intend to further research the 600 credit unions that successfully transitioned from small to large during the study timeframe. Those thriving credit unions will offer lessons for small credit unions and NCUA.

Finally, where possible, NCUA seeks to keep regulatory and examination burdens as low as possible, by exempting small credit unions from certain rules and providing them with simplified compliance approaches for others. As discussed in greater detail later in this testimony, 2015 is the year of regulatory relief at NCUA. We are diligently working to

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[7] A low-income credit union is one in which a majority of its membership (50.01 percent) qualifies as low-income members. Low-income members are those members who earn 80 percent or less than the median family income for the metropolitan area where they live, or the national metropolitan area, whichever is greater. In non-metropolitan areas, the qualification threshold is a median family income at or below 80 percent of the state median family income for non-metropolitan areas, or, if greater, the national median family income for non-metropolitan areas. Under the Federal Credit Union Act, the low-income designation offers certain benefits and regulatory relief, such as an exemption from the statutory cap on member business lending, eligibility for Community Development Revolving Loan Fund grants and low-interest loans, the ability to accept deposits from non-members, and authorization to obtain supplemental capital.

[8] Created and funded by Congress, the Community Development Revolving Loan Fund enables low-income credit unions to provide financial services and stimulate economic activities in underserved communities, as well as reach members who have limited access to basic financial services. In 2014, NCUA awarded more than $1.5 million in grants to 276 low-income designated credit unions, of which 170 were first-time awardees. Demand for these grants has consistently and significantly exceeded available appropriations.

increase regulatory flexibility and provide enhanced powers within the framework of the Federal Credit Union Act.

Regulatory Review Efforts

NCUA is ever mindful of the impact of our regulations on credit unions, especially smaller ones. We are proactive in our efforts to identify outdated, ineffective, or excessively burdensome regulations. We also continually review and take appropriate steps to eliminate or ease burdens, whenever possible, without compromising safety and soundness. We take these actions through NCUA's long-standing rolling regulatory review process, voluntary participation in the interagency Economic Growth and Regulatory Paperwork Reduction Act review process, and my Regulatory Modernization Initiative.

Rolling Regulatory Review

Since 1987, NCUA has followed a well-delineated and deliberate process to continually review our regulations and seek comment from stakeholders, such as credit unions and trade associations. Through this agency-initiated process, NCUA conducts a rolling review of one-third of our regulations each year—meaning that we review all of our regulations at least once every three years.

This long-standing regulatory review policy helps to ensure NCUA's regulations:

- Impose only the minimum required burdens on credit unions, their members, and the public.
- Are appropriate for the size of the credit unions regulated by NCUA.
- Are issued only after full public participation in the rulemaking process.
- Are clear and understandable.

Moreover, this rolling review is fully transparent. NCUA publishes on our website a list of the applicable regulations up for review each year and invites public comment on all of the regulations.[9]

Economic Growth and Regulatory Paperwork Reduction Act

Additionally, NCUA is once again voluntarily participating in the ongoing interagency review process created by the Economic Growth and Regulatory Paperwork Reduction Act of 1996.[10] EGRPRA requires the Federal Financial Institutions Examination Council and its member federal banking agencies to review their regulations at least once every 10 years to identify any rules that might be outdated, unnecessary, or unduly burdensome. NCUA is not required to participate in this process, but the agency has elected to do so.

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[9] See http://www.ncua.gov/Legal/Regs/Pages/Regulations.aspx.

[10] 12 U.S.C. 3311.

Under the EGRPRA review, each agency is issuing several categories of rules for public comment at regular intervals over two years—with an eye toward streamlining, modernizing, or even repealing regulations when appropriate. The categories developed and used by NCUA are:

- Agency Programs;
- Applications and Reporting;
- Capital;
- Consumer Protection;
- Corporate Credit Unions;
- Directors, Officers, and Employees;
- Money Laundering;
- Powers and Activities;
- Rules of Procedure; and
- Safety and Soundness.

In May 2014, consistent with the other participating agencies, the NCUA Board released for review 33 regulations in the Applications and Reporting and Powers and Activities categories. NCUA subsequently received five comments. In response to these comments, I established two internal working groups to consider possible changes in the areas of field of membership, as well as secondary and supplemental capital. The working groups conducted extensive outreach by consulting with multiple groups of stakeholders who expressed interest in these issues. The working groups are now reviewing stakeholders' suggestions from the first notice, as well as other ideas, and will make recommendations on potential regulatory and legislative changes in both areas before the end of 2015.

In the agency's second EGRPRA notice in December 2014, NCUA opened 17 rules for comment in three additional categories: Agency Programs, Capital, and Consumer Protection. In response to this notice, NCUA received eight comments from stakeholders.

After the first two EGRPRA notices, we received several actionable comments—and we have already taken action to address six important issues:[11]

- ***Easing Burdens on Small Credit Unions.*** NCUA was urged to raise the asset threshold for defining a small credit union under the Regulatory Flexibility Act from \$50 million to \$100 million. In February, the NCUA Board unanimously approved a proposed rule with the intent to consider regulatory relief for three-fourths of all credit unions in future rulemakings.

- ***Expanding Fields of Membership.*** We received several ideas to enhance federal credit union charters. Our final rule on associational common bonds was approved by a majority of the NCUA Board in April. The final rule authorizes federal credit unions to automatically add 12 categories of associations to their fields of membership.

- ***Raising Capital.*** EGRPRA commenters asked NCUA to facilitate secondary capital for low-income credit unions. We made secondary capital more attractive to

[11] More details on responses to EGRPRA comments are included in the section headed "2015: The Year of Regulatory Relief."

investors by posting timely revisions to NCUA's *National Supervision Policy Manual* in April.[12]

- ***Extending Share Insurance Coverage.*** Several EGRPRA commenters also urged NCUA to provide pass-through share insurance for escrow accounts similar to lawyers' trust accounts. In April, the NCUA Board unanimously approved a proposed rule to provide pass-through coverage for accounts managed by realtors and funeral directors. The proposal specifically sought comments on whether to extend pass-through coverage to stored-value and prepaid cards.
- ***Consumer Complaints.*** EGRPRA commenters also suggested changing the way NCUA's Office of Consumer Protection handles consumer complaints. In June, I announced NCUA's new consumer complaints process in a letter to credit unions.[13] The new process refers each complaint back to the credit union, which will have 60 days to resolve the issue with its member before our Office of Consumer Protection considers whether to intervene.
- ***Member Business Lending.*** Finally, we received a wide variety of comments to ease regulatory limits on member business loans. At our open meeting in June, the NCUA Board unanimously approved a proposed rule to remove unnecessary regulatory limits and permit credit unions to set their own prudent member business lending policies, consistent with the requirements of the Federal Credit Union Act.

Clearly, we are not waiting until the end of the EGRPRA process. We are responding to comments and taking action wherever warranted as soon as possible.

NCUA's third notice, covering an additional ten rules in three categories—Corporate Credit Unions; Directors, Officers, and Employees; and Money Laundering—was published on June 24, 2015. Comments are due by September 22. We are eager to hear new ideas about these rules, and we will consider every recommendation to improve them.

Our final notice, covering the remaining two categories—Rules of Procedure and Safety and Soundness—will be published before the end of the year.

As part of NCUA's voluntary participation in the latest EGRPRA review, NCUA is evaluating the burden on credit unions for those regulations within NCUA's control. The agency has included in the EGRPRA review all rules over which NCUA has drafting

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[12] The changes to the *National Supervision Policy Manual* will expedite the approval of secondary capital requests by NCUA regional offices and make it possible for low-income credit unions with secondary capital to return portions of the loans that no longer count towards net worth. The changes were also designed to provide investors greater clarity and confidence. See http://www.ncua.gov/News/Pages/NW20150406NSPMSecondaryCapital.aspx for more information about the low-income credit union secondary capital announcement.

[13] See http://www.ncua.gov/Resources/CUs/Pages/LCU2015-04.aspx.

authority, except for certain rules that pertain exclusively to internal operational or organizational matters, such as our Freedom of Information Act rule.

As our notice makes clear, however, credit unions also are subject to certain rules issued or administered by other regulatory agencies, such as the Consumer Financial Protection Bureau and the Department of the Treasury's Financial Crimes Enforcement Network. Because we have no independent authority or ability to change such rules, our notices—as do the joint notices prepared by the federal banking agencies—simply advise that comments submitted to us but focused on a rule administered by another agency will be forwarded to that other agency for appropriate consideration.

Regulatory Modernization Initiative

In September 2011, I launched the agency's Regulatory Modernization Initiative. The initiative balances two principles:

- Safety and soundness—strengthening regulations necessary to protect credit union members and the Share Insurance Fund; and
- Regulatory relief—revising and removing regulations that limit flexibility and growth, without jeopardizing safety and soundness.

In implementing this initiative, I have held regular in-person and online town-hall meetings to solicit feedback from stakeholders. These events have identified regulatory relief issues on which the agency has since acted.

During its first three-and-a-half years, the initiative has resulted in 18 actions to cut red tape and provide lasting benefits to credit unions of all sizes.[14] Specifically, NCUA worked to ease 10 regulations, providing regulatory relief to thousands of credit unions. NCUA also streamlined four processes, such as facilitating more than a thousand new low-income credit union designations and establishing an expedited process for examinations at smaller credit unions. NCUA additionally issued four legal opinions, allowing more flexibility in credit union operations.

2015: The Year of Regulatory Relief

Earlier this year, I announced NCUA's continuing commitment to the Regulatory Modernization Initiative's efforts to provide regulatory relief.[15] As such, NCUA is working to ease burdens and expand powers in at least six areas in 2015, including expanding regulatory relief consideration to even more small credit unions, facilitating access to supplemental capital for risk-based capital purposes, streamlining field-of-membership

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[14] See Appendix I for a complete list of these actions.

[15] See http://www.ncua.gov/News/Documents/SP20150309MatzGAC.pdf.

requirements, eliminating unnecessary fixed-assets limits, allowing qualified credit unions to securitize assets, and removing prescriptive provisions on member business lending.

During their speeches at the same conference, NCUA Board Vice Chairman Rick Metsger and Board Member J. Mark McWatters also expressed support for providing credit unions with prudent regulatory relief.[16] This relief will help credit unions of all sizes to better compete in a rapidly evolving marketplace.

Updating the Small Credit Union Definition

As noted earlier, NCUA issued a proposed rule in February to raise the asset threshold from $50 million to $100 million in assets for defining "small" credit unions under the Regulatory Flexibility Act. Under the proposal, a credit union could have up to $100 million in assets and still be small enough for consideration of regulatory relief in future rulemakings. The $100 million threshold includes 76 percent of all credit unions. The proposed threshold would also be 10-times more than the $10 million asset threshold which was in place in 2009 when I returned to the agency.

Counting Supplemental Capital for Risk-Based Capital Purposes

Over the years, NCUA has received many comments about supplemental capital. In fact, under current law, NCUA may count certain forms of debt as supplemental capital for the risk-based capital ratio. For example, subordinated debt could be issued to members and non-members, but it would be uninsured. This would require three changes beyond implementing risk-based capital.

First, we would need to provide consumer and investor protections. Second, we would need to change the order of Share Insurance Fund payout priorities to recognize that supplemental capital accounts are not insured. And third, we would need to set prudent standards for credit unions offering subordinated debt to supplement their risk-based capital. This includes setting minimum redemption periods to ensure the capital is available to cover losses during times of stress.

NCUA understands the need for supplemental capital in certain circumstances. As part of modernizing NCUA's risk-based capital rule, I am committed to allowing supplemental capital to be counted toward the risk-based capital ratio. The effective date of this change would coincide with implementation of NCUA's modernized risk-based capital rule.

Expanding Fields of Membership

NCUA is also working to provide regulatory relief by modifying our field-of-membership rules. In April 2015, a majority of the NCUA Board approved a final rule on associational

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[16] See http://www.ncua.gov/News/Documents/SP20150309MetsgerGAC.pdf and http://www.ncua.gov/News/Documents/SP20150310McWattersGAC.pdf, respectively.

common bonds granting automatic qualification to certain categories of associations the agency has routinely approved for federal credit union membership.

In all, 12 types of associational groups will receive pre-approval, including alumni associations, religious organizations, electric cooperatives, and homeowner associations, among others. With the adoption of these streamlined field-of-membership procedures, federal credit unions will now spend less time filling out unnecessary paperwork and more time fulfilling their missions by serving their members.

This final rule is the first of several significant field-of-membership improvements NCUA is pursuing this year. While remaining faithful to the Federal Credit Union Act, NCUA will propose new rules for more expansive community charters, underserved areas, and occupational charters by the end of 2015. These changes will enhance the ability of federal credit unions to serve new members.

Removing the Fixed-Assets Cap

Earlier today, federal credit unions gained relief from current limits on fixed assets under a final rule approved by the NCUA Board. Specifically, the rule eliminates the five-percent aggregate limit on investments in fixed assets for all federal credit unions and provides other targeted relief. As a result, credit unions will be able to make decisions to upgrade technology, facilities, or other fixed assets without NCUA involvement.

Permitting Asset Securitization

As the credit union system grows in size and complexity, many credit unions have adopted more sophisticated financial innovations. Later this year, NCUA will consider a final rule to permit larger, qualified credit unions to securitize their assets. Securitization would provide these credit unions a new tool to manage liquidity and interest rate risk.

Easing Member Business Lending Burdens

Finally, within the parameters of the Federal Credit Union Act, NCUA is moving away from highly rigid, one-size-fits all member business loan underwriting requirements. Last month, the NCUA Board released a proposed rule to modernize our member business lending rules. The proposal incorporates input from credit unions engaged in business lending that requested further clarity on aspects of NCUA's member business lending rules. It also addresses several issues NCUA identified as often problematic—such as the member business lending waiver process and rigid lending limits—to allow credit unions to better serve their members' individualized business lending needs.

Although NCUA's regional offices approve many waivers, the waiver process can sometimes prevent a credit union from making a timely business loan. Determining whether to exempt a borrower from a personal guarantee or a loan-to-value limit is a decision for credit union loan officers, based on prudent underwriting criteria. That's why the proposed rule eliminates the business loan waiver process and lifts unnecessary limits on construction and development loans.

The proposed amendments would also modernize the regulatory requirements that govern credit union business lending activities by replacing the current rule's prescriptive requirements and limitations—such as collateral and security requirements, equity requirements, and non-statutory loan limits—with a broad principles-based regulatory approach.

NCUA recognizes that credit unions know their members' needs better than regulators do. Business lending rules need to reflect that. Of course, NCUA will continue to provide guidance and supervise effectively for sound commercial lending practices.

Improvements in the Examination Program

Beyond issuing regulatory exemptions, expanding powers, adopting tailored rules, and removing rigid restrictions, NCUA is providing targeted regulatory relief by cutting burdens in the examination process.

Small Credit Union Examination Program

Since 2002, NCUA has followed a risk-focused exam program. This approach is designed to efficiently allocate agency resources to credit unions and areas of operations exhibiting the greatest potential risk exposure to the Share Insurance Fund. The program relies on examiner judgment to determine the areas needing review. Over time, NCUA has adjusted this approach by adding minimum scope requirements and establishing the *National Supervision Policy Manual* to ensure consistency of supervisory actions across the country.

In 2011, we determined the resources used to complete examinations were not in balance with the credit union system's risks. NCUA was spending more exam hours on the smallest credit unions rather than on the largest credit unions that have the greatest concentration of the system's assets and the greatest potential risk exposure to the Share Insurance Fund.

NCUA has since reallocated resources and concentrated supervision on credit union activities posing the most risk. The agency has put in place a targeted, streamlined examination program for financially and operationally sound federal credit unions with less than $30 million in assets. NCUA field staff also have the discretion to choose a similarly streamlined, defined-scope examination for federal credit unions with $30 million to $50 million in total assets that received a composite CAMEL rating of 1, 2, or 3 at their last examination.[17]

[17] The CAMEL rating system is based on an evaluation of five critical elements of a credit union's operations: Capital adequacy, Asset quality, Management, Earnings, and Liquidity. The CAMEL rating system is designed to take into account and reflect all significant financial, operational, and management factors that examiners assess in their evaluation of a credit union's performance and risk profile. CAMEL ratings range from 1 to 5, with 1 being the highest rating.

Through the Small Credit Union Examination Program, NCUA spends less time, on average, in small, well-managed federal credit unions. This decreased examination burden reflects a reduced overall scope but is more precisely focused on the most pertinent areas of risk in small credit unions—lending, recordkeeping, and internal control functions. As a result, between 2012 and 2014, exam and off-site supervision hours allocated to credit unions with less than $50 million in assets decreased by nearly 15 percent. During the same time period, hours allocated to large credit unions with more than $500 million in assets increased by more than 12 percent.

NCUA implemented the new procedures during the first quarter of 2015. For larger, more complex credit unions, NCUA continues to perform risk-focused exams.

Broader Examination Reforms

NCUA is further working to streamline the examination process for all credit unions by harnessing technology. Improvements in computers, software, and security are allowing NCUA to design a new Automated Integrated Regulatory Examination System and revise our Call Report system. These advancements will improve NCUA's off-site monitoring capabilities, thereby generally reducing the overall time NCUA spends onsite at credit unions conducting examinations in the future.

To improve consistency in the way field staff develop and use documents of resolution, NCUA also revised our policy and procedures in 2013 to clarify how and when documents of resolution should be used.[18] The new policy states documents of resolution should only be used to address issues significant enough that a credit union's failure to correct the problem would necessitate the examiner recommending an enforcement action. In addition, examiners must cite the appropriate law, regulation, or authoritative NCUA policy when including an issue as a finding or document of resolution in the examination report.

These procedural changes have resulted in clearer expectations for credit unions and NCUA field staff, as well as greater consistency nationwide in the examination process. As a result of these changes and an improved economy, the agency has experienced a decline in the number of documents of resolution issued.

Revised Proposed Risk-Based Capital Rule

In the wake of the Great Recession, NCUA applied the lessons we learned to put in place new rules addressing corporate credit unions, liquidity and contingency planning, stress testing, and interest rate risk, among others. At this time, modernizing risk-based capital

[18] Examiners use documents of resolution to outline plans and agreements reached with credit union officials to reduce areas of unacceptable risk. An area of unacceptable risk is one for which management does not have the proper structure for identifying, measnring, monitoring, controlling, and reporting risk.

standards for complex credit unions is the last significant safety and soundness rulemaking outstanding under the Regulatory Modernization Initiative.

The Federal Credit Union Act requires the NCUA Board to adopt by regulation a system of prompt corrective action for federally insured credit unions that is "comparable to" the Federal Deposit Insurance Act.[19] The Federal Deposit Insurance Corporation modernized its risk-based capital system in 2013. The NCUA Board unanimously proposed a comparable risk-based capital rule in January 2014.

After reviewing the comments on the original risk-based capital proposal, the NCUA Board issued a revised proposed rule in January of this year.

NCUA's primary goals for the revised proposed risk-based capital rule remain the same as the original proposal:

- To prevent or mitigate losses to the Share Insurance Fund by having a better calibrated, meaningful, and more forward-looking capital requirement to ensure credit unions can continue to serve their members during economic downturns without relying on government intervention or assistance; and
- To modernize the risk-based capital calculations and framework, in accordance with the Federal Credit Union Act's directives.

The new proposal significantly narrowed the proposed rule's scope by redefining "complex" credit unions. Under this rulemaking, a majority of the NCUA Board proposed to limit the risk-based capital requirement to credit unions with more than $100 million in assets, rather than the $50 million threshold contained in the current rule and the earlier proposal.

By increasing the asset threshold, the revised proposed rule exempts more than three-quarters of credit unions. As a result, the revised proposed rule covers 1,455 credit unions that hold 89 percent of the system's assets.[20] In comparison, the original proposal covered 2,237 credit unions representing 94 percent of the system's assets.[21] The revised proposal also would result in the downgrade of fewer credit unions.[22]

As requested by stakeholders, including many members of the House Financial Institutions Subcommittee, the revised proposed rule includes significant changes to the risk weights for investments, real estate loans, member business loans, corporate credit unions, and credit

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[19] 12 U.S.C. 1790d(b)(1)(A) and 12 U.S.C. 1831o, respectively.

[20] Data as of December 31, 2013.

[21] Data as of December 31, 2013.

[22] The reformulated risk-based capital proposal would downgrade the capital status of just 19 of 1,455 covered credit unions, based on data as of December 31, 2013. For more information about the revised risk-based based capital proposed rule, see http://www.ncua.gov/Resources/Pages/risk-based-capital-resources.aspx.

union service organizations. The risk weights contained in the new proposal are generally comparable to, or more favorable than, the risk weights applied to banks hy federal banking agencies.

Overall, 78 percent of credit union assets subject to the revised proposed rule would receive a comparable risk weight to that of the other banking agencies, and 19 percent would receive a lower risk weight. After eliminating assets not directly comparable to banks, just 3 percent of covered credit union assets would receive a more conservative risk weight than that of the other banking agencies. This is primarily due to incorporation of concentration risk, which is required by the Federal Credit Union Act for credit unions, but not required by the Federal Deposit Insurance Act for banks and thrifts.

The extended comment period on the revised proposed risk-based capital rule closed on April 27, 2015, and NCUA is thoroughly reviewing all comments received before the Board moves forward on a final rule.

NCUA Operating Budget

The NCUA Board takes stewardship of the agency's budget very seriously and exercises careful due diligence to ensure the agency prudently uses resources. In developing budgets, the agency's guiding principle is commitment to our dual mission as insurer and regulator—to provide, through regulation and supervision, a safe and sound credit union system which promotes confidence in the national system of cooperative credit.

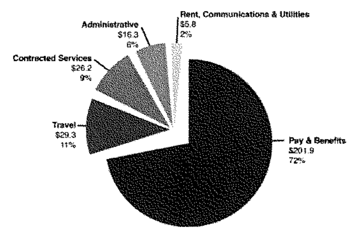
Set forth in the *NCUA Strategic Plan 2014 through 2017*, the agency's strategic goals and objectives provide a framework to ensure agency priorities and initiatives drive resulting resource needs and allocations. The agency's annual performance plans then provide the framework to execute the multi-year strategic plan and undertake tasks in NCUA's major programs. NCUA uses both the strategic and annual performance plans to develop the agency's Operating Budget.

The strategic plan, which is released for public notice and comment, includes the following priorities:

- Manage operational vulnerabilities by implementing a robust supervision framework for financial reform regulations, including interest rate risk and stress testing;
- Prepare for and promote awareness of critical risk issues and related threats such as cybersecurity risks;
- Develop and promote financial literacy education and consumer protection programs;
- Develop and communicate guidance to credit unions to explain regulatory changes and best practices; and
- Strengthen security programs and communications.

As initially approved by the NCUA Board last November, the agency's 2015 Operating Budget is $279.5 million. As shown in the chart on the next page, 72 percent of NCUA's budget is used for pay and benefits. Travel costs constitute another 11 percent of the budget, while contracted services account for 9 percent of the budget. The remaining 8 percent of the budget includes administrative expenses, as well as payments for rent, communications, and utilities.

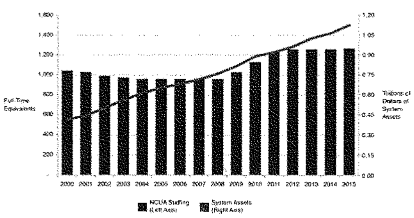
2015 NCUA Operating Budget by Component (in millions)



The 2015 budget also authorizes 1,268.7 full-time equivalent staff. After initially ramping up to respond to the system's challenges identified during the Great Recession, NCUA's overall staffing has since remained relatively flat.

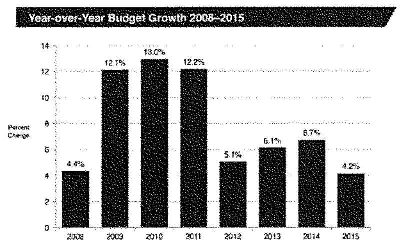
The chart below outlines the Board-approved staffing levels since 2000, in comparison to the growth in the credit union system's assets. As the chart demonstrates, NCUA during the last five years has worked to efficiently allocate our staff so as to be able to identify and mitigate risks to the system even as the assets of the credit union system have continued to grow.

NCUA Staffing Levels Compared to System Assets 2000–2015



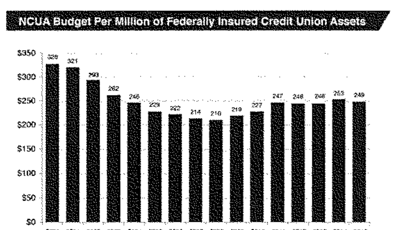
Source: NCUA Annual Budgets, Call Reports
*Federally insured credit union assets as of end of previous year

The 2015 Operating Budget represents a 4.2 percent increase over the prior year. As demonstrated in the chart below, this change was the smallest percentage increase in eight years. And earlier today, during the mid-session budget review, a majority of the NCUA Board voted to reprogram the Operating Budget and Capital Budget with a net savings of more than $1.3 million for the remainder of the year. This budget savings reflects a concerted effort by every NCUA office to increase efficiencies and reduce line items wherever possible, while still achieving the agency's mission.



Source: NCUA Annual Budgets
*All budgets approved prior to the beginning of the year.

Not only does NCUA prioritize controlling expenditures, the agency is also highly efficient. NCUA spends less than $250 protecting every $1 million in system assets. This figure is down significantly since 2000, when the cost per $1 million in system assets was $328. The chart below demonstrates the agency's commitment during the last five years to maintaining operating efficiencies and keeping spending as a portion of credit union system assets flat.



Source: NCUA Annual Budgets, Call Reports
*Federally insured credit union assets are as of end of previous year.

NCUA also achieves budget efficiency by collaborating with our state counterparts to support their oversight of federally insured, state-chartered credit unions. NCUA provides and covers the costs of training and computers for state credit union examiners. We also upload state reports into our databases. Moreover, NCUA works closely with state regulators to minimize exam burdens for 1,915 state-chartered credit unions with less than $250 million in assets. We primarily rely on state examinations at these credit unions for purposes of assessing risks to the Share Insurance Fund.

Developing the Budget

The NCUA budget process begins mid-year with each office developing a budget request identifying resources required to support NCUA's mission and strategic goals and objectives. All budgets are developed using a zero-based budgeting process. This bottom-up process means all staffing hours and each expenditure must be justified each year.

One of the primary inputs in the budget development process for NCUA's five regional offices and the Office of National Examinations and Supervision is a comprehensive workload analysis that captures the amount of time necessary to conduct examinations and supervision of federally insured credit unions. Field staff recommend the number of hours to supervise each credit union based on asset size, complexity, and financial trends. Workload estimates are then refined by each level of field management. These analyses cumulatively cover 72 percent of NCUA's total staff.

The budget submission of each office undergoes thorough review by the responsible regional or office director, the Chief Financial Officer and his staff, and executive leadership. NCUA's Information Technology Prioritization Council also meets with regional and central offices to review and prioritize software initiatives and align those information technology investments with NCUA's mission.

Throughout this iterative budget process, the Executive Director and the Chief Financial Officer regularly brief each Board Member on the overall budget proposals that are submitted, updated, and recommended. The budget and its alignment with agency mission and the strategic plan is also thoroughly vetted at each stage of the process at every level of the agency.

After months of work, NCUA's Chief Financial Officer presents the proposed Operating Budget and Capital Budget for approval during the November open meeting of the NCUA Board. As part of this process, NCUA releases a memorandum that describes the proposed budgets in detail and requested staffing levels.

Reallocating Staff

The evolution of many credit unions into larger, more complex financial institutions poses a greater concentration risk to the Share Insurance Fund. Larger, more complex institutions require more examiners with specialties in certain operations—from sophisticated investments to specialized lending to cutting-edge technology.

To efficiently manage shifting workloads, we work to reallocate existing staff and resources by aligning our budget with credit union system risks, economic trends and the agency's strategic priorities. For example, to address emerging risks, the 2015 budget reallocated 18 existing regional staff from generalists to specialists in capital markets, lending, and information systems.

The 2015 budget added a net of 4.2 full-time equivalents to achieve other important goals and objectives of NCUA's strategic plan. We achieved this change by eliminating five general examiner positions and adding nine slots to enhance supervision, cybersecurity awareness, consumer protection, small credit union assistance, and security programs.

Budget Transparency and Accountability

NCUA is committed to financial transparency and provides the public with information concerning the agency's budget and spending. As noted at the beginning of my testimony, our website has a dedicated resource center with detailed information on our budget. On this website is a wealth of budget information, including:

- Board memorandums on the budget;
- Budget briefing summaries and slides;
- Answers to budget questions submitted by stakeholders;
- Spending breakdowns by each office for all major budget categories: pay and benefits, travel, contracting, administration, rent, communications and utilities; and
- Fact sheets on: budget and financial transparency, the budget process, the agency's procedures for prioritizing information technology expenditures, the procurement process, and NCUA budget savings.

Annual financial audits of all funds under NCUA management are also posted to our website as soon as they are available. This information enhances transparency by providing detailed disclosures of our budget and budget-making processes. As a result of this online transparency, NCUA's budget disclosures greatly exceed the disclosures of other financial institutions regulators.

Recognizing the value in the exchange of ideas, I also seek insights and input on an ongoing basis from stakeholders in a variety of settings. From one-on-one meetings to town-hall settings, conferences, and coordinated field meetings, I am accessible to discuss the budget and other matters. I routinely crisscross the country speaking to and meeting with tens of thousands of credit union officials representing every state.

To further my commitment to enhanced transparency and effective communications, I have also held 18 in-person Listening Sessions and 11 online town-hall webinars since rejoining the NCUA Board, and I will host another webinar next week. My Listening Sessions and webinars are open to all interested parties.

Monthly, Quarterly, Semiannual, and Annual Financial Reports

The Chief Financial Officer also reports quarterly to the NCUA Board at public meetings on the financial status of the National Credit Union Share Insurance Fund and the Temporary Corporate Credit Union Stabilization Fund. Video, audio, and written transcripts of these reports are posted on NCUA's website for a full year.

In addition, NCUA publicly posts interim reports throughout the year on the fiscal status of the agency's four permanent funds. These funds include the:

- Operating Fund,
- National Credit Union Share Insurance Fund,
- Central Liquidity Facility, and
- Community Development Revolving Loan Fund.

The agency maintains an extensive website on the corporate resolution costs and related NCUA Guaranteed Notes used to fund the toxic corporate credit union assets. NCUA continues to update information at least semiannually to provide transparency on both the Corporate System Resolution Costs and NCUA Guaranteed Notes Program sections of our website.[23] All Stabilization Fund financial statements are posted by the Office of the Inspector General on the website, as well.[24] NCUA remains committed to informing stakeholders on the continued progress of the corporate system resolution program and will continue to publish updated information over the life of the Stabilization Fund.

The agency's securitization strategy for the toxic assets is being managed to achieve the lowest possible resolution cost. At the height of the crisis in 2009, the total unpaid principal balance for the toxic assets (mostly private-label, residential mortgage-backed securities) was $52.7 billion, but their market value was less than $22 billion. Thus, market losses from the five failed corporates would have exceeded $30 billion, an amount far in excess of the Share Insurance Fund's then $11 billion balance available to cover those losses.

As of December 2014, the unpaid principal balance of the toxic assets has declined to less than $22 billion, and the market value is $16.7 billion. The midpoint for total projected corporate system resolution costs has decreased to $8.8 billion from the original 2010 estimate of $15 billion. The economic recovery and NCUA's diligent pursuit of legal recoveries from Wall Street firms involved in the underwriting and sale of faulty securities sold to the corporates account for the improvements in overall corporate resolution cost projections. To date, NCUA has recovered more than $1.75 billion from Wall Street firms whose actions caused the failure of five corporate credit unions.

[23] See http://www.ncua.gov/Resources/Corps/RCost/Pages/default.aspx and http://www.ncua.gov/Resources/Corps/NGN/Pages/default.aspx, respectively.

[24] See http://www.ncua.gov/about/Leadership/Pages/page_oig.aspx.

NCUA's audited financial statements for all four of our permanent funds and the Temporary Corporate Credit Union Stabilization Fund, including all notes, provide a comprehensive picture of NCUA's spending and financial performance. NCUA's financial statement presentation and footnote disclosures are presented as required by Generally Accepted Accounting Principles, and all NCUA funds have received clean audit opinions. For the Share Insurance Fund, expenditure data is aggregated within the principal financial statements as required by GAAP, but more detailed information can be found within the financial statement disclosures.

Finally, in compliance with federal law, a portion of NCUA's Operating Budget is reimbursed from the Share Insurance Fund through the overhead transfer. The overhead transfer allocates expenses associated with insurance and regulatory compliance functions. The percentage of the Operating Budget paid for by the Share Insurance Fund is also presented to the NCUA Board for approval each year at the November open meeting.

NCUA's methodology for calculating the overhead transfer rate was validated in 2011 and 2013 by PricewaterhouseCoopers LLP in independent studies which were released publicly.[25] In response to feedback from the credit union community and to obtain more frequent public input on the overhead transfer rate going forward, NCUA will solicit comments on the overhead transfer rate methodology every three years in conjunction with the public review of the agency's strategic plan.

Legislative Initiatives

Before closing my testimony, I would like to reiterate NCUA's support for congressional action in three areas: vendor authority, member business lending, and supplemental capital for net worth purposes.

Vendor Authority

Since NCUA last testified in April 2015 before the House Financial Institutions Subcommittee, both the Government Accountability Office and the Financial Stability Oversight Council have recommended legislative action to provide NCUA with examination and enforcement authority over third-party technology service providers. Obtaining this authority over third-party vendors—including credit union service organizations, or CUSOs for short—is my top legislative priority.

In its July 2015 report, GAO recommended that Congress consider granting NCUA examination authority over technology service providers.[26] The GAO report notes that NCUA has a limited ability to assess the risks third-party vendors pose for credit unions and

[25] See http://www.ncua.gov/about/Documents/Budget/Misc%20Documents/2011PwCOTRReview.pdf for the 2011 study and http://www.ncua.gov/about/Documents/Budget/2013/2013ETSAnalysis.pdf for the 2013 study.

[26] See http://www.gao.gov/products/GAO-15-509.

ultimately the Share Insurance Fund, and to respond to any problems.[27] NCUA may only examine CUSOs and vendors with their permission and cannot enforce any recommended corrective actions. This lack of authority stands in contrast to the powers of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and most state regulators.

FSOC made a similar recommendation in its annual report released in May 2015.[28] Specifically, FSOC supports the granting of examination and enforcement to NCUA and to oversee third-party service providers engaged with credit unions. The report notes that this legislative change would "enhance the security of third-party service providers and the critical services they provide."

As noted in our most recent testimony before this panel, NCUA is seeking to close a critical regulatory blind spot: non-transparent, ongoing risks to the credit union system from certain types of CUSOs and third-party vendors that either originate loans or are business technology providers or payment system providers.[29] Without vendor authority, NCUA cannot accurately assess the actual risk present in the credit union system. NCUA needs the authority to determine whether current CUSO or third-party vendor risk-mitigation strategies are adequate and can effectively protect the system from a propagated contagion.

NCUA is especially concerned about our ability to effectively mitigate cybersecurity threats without third-party vendor authority. Our cybersecurity concerns predominantly relate to cyber-threats against financial services vendors, some of which may exclusively serve large numbers of credit unions or that have access to extensive personally identifiable information for millions of credit union members. NCUA needs to exercise oversight to ensure proper and robust safeguards are in place to protect such systems and data. With respect to such technology service providers, NCUA would seek information related to their cybersecurity safeguards, ongoing vulnerability assessments, and mitigation strategies in the event of their being compromised.

Today, the top five technology service providers serve more than half of all credit unions representing more than 75 percent of the credit union system's assets. Thus, a failure of even one vendor represents potential risk to the Share Insurance Fund.

The potential for losses are not hypothetical. Since 2008, nine CUSOs have caused more than $300 million in direct losses to the Share Insurance Fund and led to the failures of credit unions with more than $2 billion in aggregate assets. In one such example, one CUSO caused losses in 24 credit unions, some of which failed.

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[27] See page 32 of the report at http://www.gao.gov/assets/680/671105.pdf.

[28] See page 9 of the report at http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/2015%20FSOC%20Annual%20Report.pdf.

[29] See discussion starting on page 18 at http://www.ncua.gov/News/Documents/CT20150423Fazio.pdf.

If granted this authority, I want to assure Congress there would be no material change in NCUA's budget. NCUA does not intend to use this authority to regularly examine every CUSO or third-party vendor, especially those posing limited risks. NCUA would use this power to focus on examining those vendors with red flags or posing greater risks. When material or widespread safety and soundness issues are identified, we would have the authority to mitigate the risk and decrease losses for the Share Insurance Fund. NCUA would also coordinate with the banking regulators through the Federal Financial Institutions Examination Council to conduct third-party reviews of non-CUSOs.

Member Business Lending

NCUA also continues to support legislation to adjust the member business lending cap, such as the bipartisan Credit Union Small Business Jobs Creation Act. Sponsored by Congressmen Royce and Meeks, H.R. 1188 contains appropriate safeguards to ensure NCUA can protect safety and soundness as qualified credit unions gradually increase member business lending.

For federally insured credit unions, the Federal Credit Union Act limits member business loans to the lesser of 1.75 times the level of net worth required to be well-capitalized or 1.75 times actual net worth, unless the credit union qualifies for a statutory exemption.[30] For smaller credit unions with the membership demand and the desire to serve the business segments of their fields of membership, the restriction makes it very difficult or impossible to successfully build a sound member business lending program. As a result, many credit unions are unable to deliver commercial lending services cost effectively, which denies small businesses in their communities access to an affordable source of credit and working capital.

These credit unions miss an opportunity to support the small business community and to provide a service alternative to the small business borrower. Small businesses are an important contributor to the local economy as providers of employment, and as users and producers of goods and services. NCUA believes credit union members that are small business owners should have full access to financial resources in the community, including credit unions, but this is often inhibited by the statutory cap on member business loans.

Supplemental Capital for Net Worth Purposes

Finally, NCUA reiterates our support for legislation to allow more credit unions to access supplemental capital, such as H.R. 989, the Capital Access for Small Businesses and Jobs Act. Introduced by Congressmen King and Sherman, this bipartisan bill would allow healthy and well-managed credit unions to issue supplemental capital that will count as net

[30] 12 U.S.C. 1757a.

worth. This legislation would result in a new layer of capital, in addition to retained earnings, to absorb losses at credit unions.

The high-quality capital that underpins the credit union system is a bulwark of its strength and key to its resiliency during the recent financial crisis. However, most federal credit unions only have one way to raise capital—through retained earnings, which can grow only as quickly as earnings. Thus, fast-growing, financially strong, well-capitalized credit unions may be discouraged from allowing healthy growth out of concern it will dilute their net worth ratios and trigger mandatory prompt corrective action-related supervisory actions.

A credit union's inability to raise capital outside of retained earnings limits its ability to grow its field of membership and to offer greater options to eligible consumers. Consequently, NCUA has previously encouraged Congress to authorize healthy and well-managed credit unions to issue supplemental capital that will count as net worth under conditions determined by the NCUA Board. Enactment of H.R. 989 would lead to a stronger capital base for credit unions and greater protection for taxpayers.

NCUA stands ready to work with Congress on H.R. 989, H.R. 1188, and the agency's legislative proposal on vendor authority.

Conclusion

In closing, the credit union system is now headed in the right direction. Both the credit union system and NCUA are in remarkably better condition than when I became Chairman.

We have ensured that NCUA has the resources needed to effectively oversee credit unions. NCUA has also worked to put in place new rules to protect the credit union system and provide regulatory relief through the Regulatory Modernization Initiative. I will continue working to protect the safety and soundness of credit unions and to safeguard the 100 million credit union account holders who are federally insured by NCUA.

I look forward to your questions.

APPENDIX I

National Credit Union Administration
Regulatory Modernization Initiative
September 2011–June 2015 Results

NCUA ACTIONS	BENEFITS
IMPROVED RULES	
Modernized Definition of "Small" Credit Unions	• In 2013, expanded NCUA's consideration of regulatory exemptions for credit unions with assets of less than $50 million, up from the previous $10 million. • Exempted two-thirds of the entire credit union system from NCUA rules on risk-based net worth and interest rate risk management. • Eased the compliance requirement for small credit unions to access emergency liquidity. • Doubled the number of credit unions receiving special consideration for regulatory relief in future NCUA rulemakings. • To further regulatory relief, in 2015 the NCUA Board proposed to double the threshold to $100 million.
Eased Troubled Debt Restructurings	• Encouraged credit union loan modifications and ended manual reporting. • Prevented unnecessary foreclosures. • Kept more credit union members in their homes throughout the crisis.
Expanded Rural Districts	• Raised potential membership for federal credit unions in rural districts from a hard cap of 200,000 residents to a sliding scale: 250,000 residents or 3 percent of the state population, whichever is larger. • Permitted federal credit unions to serve rural districts and Indian reservations in states experiencing extraordinary population growth, as well as in smaller states.
Authorized "Plain Vanilla" Derivatives	• Encouraged qualified federal credit unions to use "plain vanilla" derivatives to reduce risks. • Permitted approved federal credit unions to continue mortgage lending while offsetting interest rate risk. • Protected the credit union system by providing an extra buffer against potential losses at large credit unions.
Approved Treasury Inflation-Protected Securities	• Offered federal credit unions an additional investment backed by the federal government with zero credit risk. • Provided returns indexed to inflation rates rather than interest rates.
Established Charitable Donation Accounts	• Empowered federal credit unions to safely pool investments designed to benefit national, state, or local charities.
Eliminated the Fixed-Assets Cap	• Eliminated federal credit unions' 5-percent cap on fixed assets. • Empowered federal credit unions to make their own business decisions on purchases of land, buildings, office equipment, and technology.
Proposed Asset Securitization	• Would let qualified federal credit unions to securitize their own assets. • Offered as an additional tool to manage interest rate and liquidity risks.

NCUA ACTIONS	BENEFITS
Expedited Field of Membership Expansions	• Authorized 12 new types of associational groups to receive automatic pre-approval for inclusion in a federal credit union's field of membership.
Proposed Modernizing Member Business Lending	• Removed rigid requirements to provide credit unions with greater flexibility and individual autonomy in prudently providing member business loans. • Implemented a principles-based regulatory approach to commercial lending.
STREAMLINED PROCESSES	
Low-Income Credit Union Designation	• Implemented an "opt-in" process whereby eligible credit unions can simply say "yes" to receive the low-income designation. • More than doubled the number of low-income designations, reaching more than 2,300 credit unions serving 30 million members. • Low-income credit unions are authorized by statute to expand member business lending beyond the statutory cap, obtain supplemental capital, raise non-member deposits, and apply for Community Development Revolving Loan Fund grants and loans.
Blanket Waivers	• Released guidance encouraging credit unions to apply for blanket waivers for member business loans meeting certain conditions. • Eliminated the requirement for many business owners to pledge personal guarantees against loans with high-value collateral based on sound underwriting principles.
Expedited Examinations	• Created an expedited exam process for well-managed credit unions with CAMEL ratings of 1, 2, or 3 and assets of less than $30 million, with the program expanding to $50 million in 2015. • Enabled these credit unions to dedicate more resources to serving members.
Facilitated Secondary Capital	• Provided policy flexibility for low-income credit unions to redeem secondary capital at investors' requests.
ISSUED LEGAL OPINIONS	
Extended Loan Maturities	• Permitted loan maturities up to 40 years after loan modifications. • Significantly reduced monthly payments for borrowers in need.
Expanded Vehicle Fleets	• Modernized the definition of "fleet" from two to five vehicles for member business loans. • Provided regulatory relief and expanded access to credit for small businesses and startups.
Modernized Service Facilities	• Included full-service video tellers in the definition of federal credit union service facilities. • Empowered federal credit unions to expand services in underserved areas without necessarily purchasing more brick-and-mortar branches.
Changing Charters in Mergers	• Permitted credit unions to change charters to facilitate voluntary mergers. • Retained credit union service for members of merging credit unions.

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July 22, 2015

The Honorable Randy Neugebauer
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
Washington, DC 20515

The Honorable Lacy Clay
Ranking Member
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
Washington, DC 20515

Dear Chairman Neugebauer and Ranking Member Clay:

We understand that the Subcommittee plans to hold an oversight hearing Thursday, July 23 to look into the National Credit Union Administration (NCUA). We strongly commend the Subcommittee's efforts to provide much needed oversight of the NCUA. Although the hearing will be focused on NCUA's budget, we write to make you aware of what we believe are much more serious issues that warrant strong Congressional oversight. Once called a "rogue federal agency" by a federal judge, over the past month it has become obvious that NCUA has again become a cheerleader for the $1 trillion industry it is charged with supervising.

Congress established a very specific statute designed to focus the credit union industry, which enjoys a massive $25.39 billion federal subsidy over 10 years from its tax exemption, on its mission to serve consumers of modest means. However, in the name of "regulatory relief," NCUA's Chairman has announced her intention to circumvent the most critical statutory limits, despite Congress's continued choice <u>not</u> to enact reforms. In a June 25, 2015 speech, NCUA's Chairman announced that she will provide what amounts to the credit union industry's entire legislative agenda—dramatically increased business lending authorities, field of membership expansion, and supplemental capital—through regulation. **"Regulatory relief" does not mean promoting explosive growth of the credit union industry at the expense of taxpayers, community banks, or the communities those banks serve.**

The agency's new proposed rule on business lending is a stunning snub to Congress. NCUA claims authority to raise the statutory cap on credit union business lending through regulatory fiat. The 12.25% of assets cap was a deliberate policy choice made "to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, *through an emphasis on consumer rather than business loans*."-- Senate Banking Committee Report 105-193. Acting with willful blindness to Congressional intent, NCUA now claims 12.25% is "shorthand" for the cap, and that the agency can raise it on its own. This is a striking about face; NCUA's current Chairman testified to Congress twice in 2011 that 12.25% <u>is</u> the cap, and advocated for legislation to raise it—legislation unnecessary if NCUA had these powers all along. NCUA's creative reading of the statute is also incorrect, a detailed conversation we are happy to have with the Committee.

NCUA's proposal would also make the cap irrelevant, an even more troubling reality. By removing limits on business loan participations to non-members and "clarifying" that these loans are exempt from the 12.25% cap, NCUA will enable a massive, risky loan syndication program that will allow credit unions a much higher concentration in business loans. This will enable credit unions to engage even further in risky activities like large multimillion-dollar commercial real estate lending, fueled by a taxpayer subsidy. NCUA has not established that it is prepared to supervise institutions with a dramatically expanded business loan portfolio. This is an agency with a demonstrated poor track record when it comes to supervision, as has been chronicled by the Government Accountability Office and NCUA's own Inspector General. NCUA says it will provide guidance to credit unions and a comprehensive examiner re-training program. However, this amounts to on-the-job training for a federal agency that has time and again shown a lack of sophistication, yet whose insurance program enjoys the full faith and credit of the United States.

Compounding these abuses, NCUA's Chairman promised in that June 25th speech that the agency will propose new rules before the end of 2015 to expand fields of membership and provide authority for partial supplemental capital. While these proposals have not been finalized, we are troubled by multiple public statements from at least one NCUA board member suggesting that a primary goal is to help the industry grow. Facilitating growth at credit unions is not NCUA's job. Rather, it is charged with protecting the taxpayers who back its insurance fund. We must remember that as this massive tax exempt industry seeks to expand, it does so at the expense of taxpayers. Congress should ask the difficult questions of NCUA about why the agency is undertaking these efforts. In particular, Congress should examine the potential impact such actions could have on safety and soundness and lost federal tax revenue, and if they undercut the very purpose of the credit union tax exemption.

In the same speech, NCUA's Chairman also took credit for the agency's efforts to "streamline" the designation for low-income credit unions, which Congress established to help credit unions in poor communities. It is no coincidence that the authorities provided to low income credit unions—an exemption from the business loan cap, supplemental capital authority, and the ability to accept non-member deposits from any source—are the perennial favorites on Capitol Hill for the credit union lobby. According to Chairman Matz, 47% of all federal credit unions now receive the low-income designation. These numbers are so high that we question whether the agency is giving credit unions a serious look at whether the "low-income" designation is appropriate. Moreover, NCUA's definition of "low income" is so broad as to capture tens of millions of people who are far from low income, such as the campus communities at Harvard and Georgetown, and the residents of Connecticut's Gold Coast, including Stamford, Greenwich, and Norwalk. We encourage Congress to ask for an explanation of whether NCUA is using the low income designation as intended, or using it as a tool to empower credit unions to skirt the law.

For years, NCUA has demonstrated its greatest interest is serving as an enabler for an industry that is already subsidized by its tax exemption. Congress should be very concerned at NCUA's recent actions. We hope NCUA will reconsider its statutory obligations and focus its efforts on reaching those for whom the credit union industry was truly created. Meanwhile, we hope Congress will aggressively exercise its oversight function and reorient this out of control agency.

Sincerely,

Frank Keating

cc: Members of the House Committee on Financial Services

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July 22, 2015

The Honorable Randy Neugebauer
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Lacy Clay
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Subcommittee Chairman Neugebauer and Ranking Member Clay:

On behalf of the Credit Union National Association (CUNA), I am writing to thank you for holding this week's hearing entitled, "National Credit Union Administration Operations and Budget." CUNA represents America's credit unions and their more than 100 million members. We respectfully ask that this letter be included as part of the record of the hearing.

The ever-increasing and ever-changing regulatory burden credit unions face means that credit and services are less available and more expensive for members. We appreciate the efforts of the Committee to understand the burden small institutions face and the emphasis you placed on removing unnecessary barriers so that credit unions can more fully serve their members and communities.

The National Credit Union Administration (NCUA) is the prudential regulator for federally chartered credit unions and administers the National Credit Union Share Insurance Fund (NCUSIF) for federally insured credit unions. The NCUSIF and nearly all of the operating expenses of the agency are funded through credit union member resources; this means that a portion of the funds that could be used by credit unions to benefit your constituents with lower loan rates, fewer fees, and higher interest rates on deposits are instead set aside to fund the regulation and insurance of the credit union system. In the past, NCUA has held regular budget hearings to allow stakeholders to weigh in on the operations of the agency; however, those hearings were discontinued in 2009. In the intervening years, the NCUA budget has continued an expansive trend while at the same time the budgets of other federal banking regulators have decreased. For all of these reasons, it is critically important that the subcommittee exercise regular and thorough oversight of NCUA to ensure that credit union member resources are efficiently and appropriately used. We greatly appreciate your calling this hearing to hear from NCUA Chairman Matz on this issue.

While the efficient and appropriate use of credit union member resources at NCUA is critical, as outlined below, there are several other issues that we encourage you and others on the Subcommittee to explore with Chairman Matz.

NCUA's Risk-Based Capital Proposal Misses the Mark and Congress Should Consider Statutory Changes to Credit Union Capital Requirements

One lesson of the financial crisis is "capital is king" and the measures used to assess the capital condition of many of our nation's banking institutions were imperfect. Financial regulators, including NCUA, have worked in recent years to impose "better" schemes to assess the health of financial institutions; NCUA's new risk-based capital proposal (RBC) is its latest attempt in this area.

While we appreciate the significant improvements that NCUA has made to the second version of this proposed rule (RBC2), we continue to question whether NCUA has the statutory authority to set a risk-based standard for determining whether a credit union is well-capitalized, as opposed to adequately capitalized, and we also question whether the cost of implementing the proposal outweighs the benefit to the National Credit Union Share Insurance Fund (NCUSIF). To state it clearly: we still believe this proposal is a solution that will not work in search of a problem that does not exist in the credit union system.

The question of legal authority to set a risk-based capital standard for the purposes of determining whether a credit union is well capitalized is a critical question for Congress to explore. Attached to this letter is a legal opinion supporting our view that NCUA lacks the authority to issue the rule it has proposed. This position is also supported by several Members of Congress who were directly responsible for the development of this provision of the Federal Credit Union Act (FCUA), and who commented on the previous proposal, including the former chairman of the Senate Banking Committee Alfonse D'Amato, who said:

> "[W]hen we included in the law the language: 'The Board shall design the risk-based net worth requirement to take account for any material risk against [which] the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection,' we meant just that, adequately capitalized. If we had intended there should also be a separate risk-based requirement to be well capitalized (in addition to the 7% net worth ratio), we would have said so."[1]

Given the preponderance of evidence which suggests that NCUA does not have the authority to establish a risk-based capital requirement for the purposes of determining whether a credit union is well-capitalized, we have urged NCUA in the strongest terms possible to withdraw the proposal or revise it consistent with current law.

[1] Letter from Senator Alfonse M. D'Amato to Mr. Gerard Poliquin, Secretary of the Board, National Credit Union Administration. May 7, 2014.

Another very troubling provision in RBC2 is the capital adequacy requirement. This provision could be among the most problematic for credit unions in RBC2 because it would grant examiners considerable latitude to determine whether a credit union needs more capital - even if it meets the regulatory requirement of being well-capitalized according to standard net worth and risk-based capital ratio requirements. What use are regulatory capital requirements if the examiner can come into the credit union and demand more? The boards of directors and executives running credit unions need certainty in this area, not unpredictable, subjective requirements set by examiners.

As part of its RBC2 proposal, NCUA provided advance notice that it intends to consider a new proposal related to interest rate risk. Our comment letter on this matter, also attached to this letter, provides a greater level of specificity but in summary, we question whether a new rule on interest rate risk is necessary given the fact that NCUA presently has many supervisory tools that could be used to identify unreasonable interest rate risk at individual credit unions. We ask the Subcommittee to explore with the agency whether a new rule is necessary or whether this might be better monitored through improvements in the supervisory process.

NCUA should withdraw this proposal. In lieu of that, NCUA should improve RBC2 by fixing risk weightings, applying the rule only to adequately capitalized credit unions, as required by the Federal Credit Union Act (FCUA), removing subjective capital adequacy requirements and allowing supplemental capital to be used for RBC purposes. Further, we believe the Subcommittee should consider H.R. 2769, the Risk-Based Capital Study Act, which would delay implementation of this proposal until NCUA has conducted further analysis of its impact on credit unions.

Statutory Changes to Credit Union Capital Requirements Are Necessary

It has been nearly 20 years since Congress imposed statutory capital requirements on credit unions, and the time has come to revisit those standards. We encourage Congress to consider comprehensive reforms to the credit union capital structure, including authorizing NCUA to define what the different net worth levels must be in order to be "well-capitalized," "adequately capitalized," "undercapitalized," and "significantly undercapitalized," based on credit unions' financial performance, current economic trends and other relevant factors.

NCUA has supported H.R. 989, the "Capital Access for Small Businesses and Jobs Act" which would grant NCUA the authority to allow all credit unions to accept supplemental forms of capital. CUNA strongly supports this bill because it would strengthen the safety and soundness of the credit union system by allowing additional non-ownership forms of capital to be accepted by credit unions. Under current law, approximately 2,000 credit unions, those designated as low-income credit unions, have this authority. Permitting all credit unions to acquire supplemental capital in a manner consistent with their cooperative ownership structure would enhance the safety and soundness of the credit union system.

The Honorable Randy Neugebauer
The Honorable Lacy Clay
July 22, 2015
Page 4

NCUA Should Improve Analysis of Its Rulemakings and Congress Should Require Public Hearings on the NCUA Budget

We encourage Congress to require NCUA to complete an extensive cost-benefit analysis before the agency proposes any rule and to provide this analysis with any proposal that is issued for comment. It is reasonable that credit unions should be provided with an analysis of the cost and the benefit of proposals the regulator is proposing. Credit unions fund NCUA and the NCUSIF, incur costs at the credit union level when new rules are adopted, and have a vested interest in the health of the system and the effect any new rule may have upon them.

We encourage the Subcommittee to consider H.R. 2287, a bill to require the NCUA Board to conduct an annual public hearing on the agency's draft budget. While we appreciate the opportunity to discuss budgetary concerns with the Board in advance of action on the budget, it is fair and reasonable for the Board to take public comments for the record prior to taking action on a budget that relies on credit union member resources. Conducting such a hearing would allow NCUA board members the appropriate time to review the suggested budget, allow stakeholders to witness the proceeding, and be incredibly meaningful to the credit unions that are responsible for funding the activities of the agency because they would have the ability to submit comments before the budget is finalized. Similar hearings were held for several years until they were discontinued in 2009. Until such time that a law can be enacted to compel the agency to provide such a forum for credit union stakeholders, we encourage the Subcommittee to ask the Chairman of the NCUA to testify annually on the agency's budget.

NCUA Examinations Remain Problematic; Congress Should Enact Examination Fairness Legislation

Credit unions support strong, fair and appropriate safety and soundness regulation and supervision to protect financial resources and their members and to minimize costs to the NCUSIF borne by all federally insured credit unions. Examinations should be based on the laws Congress enacts and the regulations that NCUA promulgates, not on an examiner's interpretation of best practice or guidance. CUNA continues to hear concerns from its members regarding credit union examinations, as evidenced by a recently conducted survey.[2]

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[2] CUNA/league affiliated credit unions received ongoing email correspondence from CUNA and their state league presidents inviting them to complete an on-line survey on their most recent exam. In addition, the survey was prominently featured on CUNA's website, in CUNA newsletters, and by leagues in a number of their communications with credit unions. The questionnaire was almost identical to one used in both 2012 and 2013. By September 10, 2014, we had received 447 responses, representing approximately 7% of all credit unions. On average, responding credit unions were once again somewhat larger than all US credit unions: For example, 37% of responding credit unions reported \$25 millon or less in assets, while roughly 50% of all U.S. credit unions are this large. At the other end of the spectrum, 23% of responding credit unions have more than \$250 million in assets compared to 11% of the population. In any case, there was strong response across all asset sizes. Because larger credit unions were more likely to respond, responses from single common bond credit unions were lower than the population, and community charters are more heavily represented. All totals reported in the survey will be weighted to the distribution of all credit unions by asset size when the final report is released, though doing so is unlikely to significantly change the observations found in this preliminary summary of findings.

Twenty eight percent of credit unions reported dissatisfaction with their most recent exam. Excessive use of documents of resolution, applying "guidance" or "best practice" as if it was regulation, and examiners taking action to "cover" themselves stood out as the items that received the most negative ratings. Further, CUNA continues to hear issues about disconnects between the guidance of NCUA and the implementation by the examiners in the field. This results in extra time, costs, and burden to resolve exam disputes which should otherwise be unnecessary. This, coupled with NCUA's lack of an independent appeals process, to dispute determinations made in its exams leave the regulator in some instances unaccountable for its actions.

Credit unions need an examination appeals process that is independent and protects them from examiner retaliation. To date, we are aware of no credit unions which have successfully appealed an examination decision. We believe an independent process at the Federal Financial Institution Examination Council (FFIEC) would improve the appeals process and lead to fairer exams.

CUNA supports Rep. Westmoreland's bill, H.R. 1941, the "Financial Institutions Examination Fairness and Reform Act" that will codify certain examination standards, provide an independent ombudsman to whom credit unions and banks could raise concerns about their exams, and create an independent appeals process under which they could dispute determinations made in their exams.

Credit union have also expressed concern with the frequency of exams. We hope the Subcommittee will encourage NCUA to refine the cycle for examinations to be more consistent with the examination cycle for banks.

NCUA Should Extend Share Insurance Coverage to Prepaid, Payroll and Other Stored Value Cards

NCUA recently closed comments on a proposed rule that would make necessary changes required by the Credit Union Share Insurance Fund Parity Act (CUSIFPA or H.R. 3468). Unfortunately, NCUA did not propose to extend share insurance to prepaid, payroll and other stored value cardholders. The FCUA gives NCUA the authority to insure these cards and this authority has been amplified by H.R. 3468, which adds additional language to the FCUA allowing NCUA to provide share insurance to "other similar escrow accounts," which encompasses these cards.

Allowing share insurance coverage to prepaid, payroll and other stored value cards will allow credit unions to better serve their small business members who wish to compensate employees though this form of payment, which has the added benefit of protecting the unbanked from costly check cashing fees. NCUA should follow the lead of other regulators and Congress by extending deposit insurance coverage to the aforementioned accounts.

NCUA Has the Authority It Needs With Respect to Third Party Vendors

We are deeply concerned that NCUA continues to urge Congress to convey to the agency supervisory authority over vendors and credit union service organizations (CUSOs). Further, we are troubled by the agency's recent assertion that having such authority would represent regulatory relief for credit unions.[3]

CUNA opposes new statutory authority for NCUA to regulate and supervise directly Credit Union Service Organizations (CUSOs) or other third party entities that provide products and services to credit unions. Credit unions are already supervised for due diligence in third-party vendor relationships during their regular examinations, and many of the third parties on which credit unions rely also serve banks and, therefore, are subject to supervision by banking regulators. Further, we question the capacity of the agency to supervise these entities, and we fear the cost of making the agency capable of such supervision – which would be paid with credit union member resources – would vastly outweigh the benefit derived from such supervision. Giving NCUA additional, and redundant, authority to supervise third party vendors would increase the cost of the services these entities provide credit unions without providing any added benefit to the agency.

We are also unconvinced that NCUA needs authority to regulate CUSOs inasmuch as CUSOs are generally owned by credit unions, subject to a statutory restriction that guards against concentration risk. The agency should be able to get the information it needs regarding CUSOs from the credit unions that own them.

We encourage the Subcommittee to reject NCUA's request for additional supervisory authority.

Statutory and Regulatory Changes Are Necessary to Ensure Credit Unions Can Continue to Meet the Needs of Their Business Lending Members

We reiterate our call on Congress to restore credit unions' authority to lend to their small business members, by enacting H.R. 1188, the "Credit Union Small Business Jobs Creation Act". No economic or safety and soundness rationale has ever been established for why credit unions should be subjected to a cap on small business lending, and we believe Congress should fully restore credit unions' ability to lend to their small business members, as they did without statutory restriction until 1998.

As we have testified many times before, while the small banks were asking for taxpayer money to lend to small businesses, credit unions were pleading with Congress to permit well-capitalized credit unions with a strong history of business lending to lend beyond the arbitrary cap on business lending that is in statute, with no cost to the taxpayer.

[3] Fazio. 15. [is this FN correct?]

The facts are not in dispute. During the financial crisis, banks withdrew access to credit for small businesses while credit unions kept lending. Anecdotally, we are aware of several instances in which banks referred business lending customers to credit unions, because they were unable to make the loans themselves.

NCUA has testified in support of expanding the business lending cap several times, most recently before the Senate Banking Committee in February.[4] The administration has supported expanding the business lending cap.[5] There are close to 500 credit unions for which the cap is a significant operational restriction. These credit unions deserve the opportunity to continue to serve their business members and their communities, and Congress should address this issue.

NCUA recently proposed a new member business lending regulation that would remove many burdensome and restrictive requirements from regulation. While we continue to study the proposal, which is still open for comment, our initial analysis of the proposal is that it could facilitate credit union business lending provided that the reduction in regulatory burden is not replaced with inconsistent or unreasonable requirements imposed by examiners.

Low Income Designation

The FCUA exempts credit unions designated as low income by NCUA from statutory member business lending restrictions, and allows them to accept nonmember deposits and to access supplemental capital. We have encouraged NCUA to make the low-income status more available, more transparent and more certain for credit unions. The agency in recent years has helped identify credit unions that qualify for the status, but often times these credit unions do not know how they have qualified or how close they may be to becoming disqualified. Further, when the credit union drops below the level at which they are qualified to be low-income, they are required to divest business lending above the statutory cap within five years. We have asked the agency to give credit unions more time to get back on track if they temporarily drop below the low-income threshold. NCUA and Congress could help credit unions by creating a process that allows credit unions to obtain low-income status permanently.

Overhead Transfer Rate

The FCUA authorizes the NCUA board to expend funds from the Share Insurance Fund for the "administration and other expenses" related to federal share insurance. The percentage of NCUA's operating budget which comes from this transfer is the Overhead Transfer Rate. CUNA opposes any overhead transfer of agency expenses to the NCUSIF that are not legitimate, substantiated "insurance-related" costs, consistent with fairness to state and federal credit unions

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[4] Testimony of Larry Fazio, Director, Office of Examination and Insurance, National Credit Union Administration, before the Senate Banking Committee Hearing on "Regulatory Relief for Community Banks and Credit Unions." February 10, 2015.

[5] Letter from U.S. Secretary of Treasury Timothy Geithner to House Financial Services Committee Chairman Barney Frank. May 25, 2010.

and the FCUA. The NCUA Board should fully communicate its analysis and proposal regarding the overhead transfer rate to the credit union community in a timely manner prior to setting a new overhead transfer rate, and stakeholders should be able to comment on this proposal.

Capital Planning and Stress Testing

We have significant concerns regarding NCUA's stress testing requirements for very large credit unions. NCUA has not sufficiently substantiated the need for a capital planning and stress testing regulation, given the financial performance of credit unions in general and the largest credit unions that would be covered by the rule in particular. The fact that Congress under the Dodd-Frank Act did not include NCUA among the agencies directed to implement capital plans or stress testing for the largest institutions they regulate supports our view that this regulation is not the best course of action. This is an example of NCUA applying rules designed for the largest financial institutions to credit unions that, while large relative to other credit unions, are small in comparison to mega-banks and other large financial institutions.

We are deeply concerned about the costs that the agency has estimated would be associated with the final rule. Agency staff have indicated that the rule initially will cost the agency $4 million, or $1 million per covered credit union, to implement. NCUA has not shared with credit unions how it arrived at the $4 million estimate, and we feel the agency should have provided more information regarding these cost projections. We have concerns that the implementation costs could even exceed this already extremely high estimate, and we are not sure what benefit the agency aims to glean from this effort since these institutions regularly conduct their own stress tests. In addition, the cost burdens placed on credit unions to comply with these new requirements are likely far in excess of the estimated costs to the agency.

NCUA Involvement with Accounting Standards

CUNA recently contacted NCUA Chairman Matz to ensure NCUA is aware of CUNA's continuing grave concerns regarding the Financial Accounting Standards Board's (FASB) pending rule change on accounting for credit impairment.

The pending change, which was proposed in December 2013 and is expected to be finalized by the end of this year, will require credit unions to utilize a current expected credit loss (CECL) model on all financial assets and financial liabilities. This approach will have a dramatic impact on credit unions, due primarily to a change that will require them to hold much more in reserves for future possible loan losses, despite the fact that credit union loan loss reserving has proved to be more than adequate, even during the recent financial crisis.

While the proposal will in no way change economic reality, it will result in lower apparent capital ratios at credit unions and banks. Therefore, we hope NCUA will instruct examiners to make the appropriate adjustments in assessments of capital adequacy in order to minimize the

The Honorable Randy Neugebauer
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negative impact on credit unions. To illustrate this, assume under the CECL approach a credit union's net worth ratio falls by 50 basis points. In such an instance, an examiner who otherwise might have suggested, for example, a 9% net worth ratio should now be satisfied with 8.5%.

As communicated previously to NCUA, CUNA urges NCUA to work with FASB as it finalizes these changes. Since FASB appears reluctant to consider any major changes to the proposal, we believe it is critical that FASB hear directly from federal financial regulatory agencies, including NCUA.

Conclusion

On behalf of America's credit unions and their more than 100 million members, thank you very much holding this hearing and considering our views. We look forward to continuing to work with this Committee on enacting into law meaningful regulatory relief for credit unions and their members.

Sincerely,

Jim Nussle
President & CEO

Attachments

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memorandum

TO	Eric Richard General Counsel Credit Union National Association Mary Dunn Deputy General Counsel Credit Union National Association	DATE	September 18, 2014
FROM	John Cooney William Donovan	EMAIL	jfcooney@venable.com wjdonovan@venable.com
RE	Analysis of NCUA's Risk-Based Net Worth Proposal		

We have attached a document for CUNA's use in presenting its arguments to external constituencies that NCUA's proposal to establish a minimum risk-based net worth requirement for a complex credit union to be classified as well capitalized violates the express language of the Credit Union Membership Access Act; and that the rationale for this approach that NCUA has set forth in recent letters to Members of Congress is unlawful because it violates the explicit language of that statute.

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memorandum

TO	Eric Richard General Counsel Credit Union National Association Mary Dunn Deputy General Counsel Credit Union National Association	**DATE**	September 18, 2014
FROM	John Cooney William Donovan	**EMAIL**	jfcooney@venable.com wjdonovan@venable.com
RE	NCUA's Proposal To Establish a Separate Risk-Based New Worth Requirement for a Complex Credit Union To Be Classified as Well Capitalized Is Unlawful Because It Violates the Plain Language of the Statute		

The National Credit Union Administration Board lacks statutory authority to establish a minimum 10.5 percent risk-based net worth requirement for a complex credit union to be classified as "well capitalized," as proposed in § 702.102(a)(1)(ii) of its Proposed Rule. Issuance of such a provision in the final rule would be plainly unlawful.

The literal language of Section 301 of the Credit Union Membership Access Act ("CUMAA"), Pub. L. No. 105-219, 12 U.S.C. § 1790d, and its supporting legislative history demonstrate that Congress granted NCUA authority only to establish a *single* risk-based net worth requirement for complex credit unions – the standard that a credit union must meet to be classified as "adequately capitalized" – and did *not* grant the agency the power to promulgate a separate risk-based standard for a credit union to be classified as "well capitalized." To the contrary, the express language of Section 1790d provides that the identical risk-based net worth requirement that is applicable in determining whether a complex credit union is "adequately capitalized" also must be applied in determining whether that institution satisfies the criteria for classification as "well capitalized."

A key provision to understanding the limits on NCUA's authority to establish risk-based capital is 12 U.S.C. § 1790d(d)(2), which Congress in drafting CUMAA intentionally and appropriately labeled "Standard." By including a "standard" for the agency to follow, Congress intended not only that NCUA develop its risk-based capital system consistent with this provision but also that it refrain from developing a risk-based capital system that did not reflect this language.

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Congress left no ambiguity regarding its intentions; the plain language of the standard it established in 12 U.S.C. § 1790d(d)(2) directs NCUA to:

> design the risk-based net worth requirement to take account of any material risks against which the net worth ratio for an insured credit union to be adequately capitalized may not provide adequate protection.

The words themselves could not be clearer in setting the course for NCUA to follow. The language leaves no doubt that Congress meant for NCUA to develop a risk-based capital standard for complex credit unions using a model that synchronizes risk-based capital with net worth requirements for adequately capitalized credit unions, and not set a higher risk-based capital threshold for well capitalized credit unions.

Congress could have crafted a standard that left out the words "adequately capitalized"; had it done so NCUA would have much greater latitude to develop a risk-based capital system that imposes a higher level for well capitalized credit unions to attain. However, since that is not what Congress did NCUA may not and must not ignore the plain language that risk-based capital must be designed so that adequately capitalized credit unions will have a combination of Tier I and risk-based capital that provides them "adequate protection," without imposing even higher risk-based capital requirements on well capitalized credit unions.

Moreover, as discussed more thoroughly below, Members of Congress who helped develop and manage the passage of the Prompt Corrective Action ("PCA") provisions included in CUMAA have emphasized that Congress intended the adequately capitalized level to be the benchmark to which additional risk-based capital would be applied.

Some have suggested that an analysis of Congressional intent regarding risk-based capital requirements should not focus on this singular provision. However, no other provision in 12 U.S.C. 1790d so squarely addresses the scope and limits of NCUA's authority in setting the risk-based capital standard. It is a longstanding principal of statutory construction that general provisions, even when strung together to form an argument, do not dilute or outweigh specific directives Congress has included in a statute.

Thus, even when all other relevant provisions regarding how risk-based capital requirements are considered, the conclusion is the same. The statute does not give NCUA the flexibility to impose a higher risk-based capital standard on well capitalized credit unions than it imposes on adequately capitalized credit unions.

A provision that mentions "risk-based net worth" generally is Section 1790d(c), net worth categories. Under Subsection (c)(1)(A), a well capitalized credit union must have a net worth ratio of not less than 7 percent and must meet any applicable risk-based net worth requirement under subsection (d) – the very provision addressed above that tells NCUA how the risk-based capital standard is to be designed.

While Section 1790d(c) states that a well capitalized credit union must meet any applicable net worth requirement, the provision does not override or contradict Subsection (d).

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Rather, it provides that a well capitalized credit union must comply with an applicable risk-based capital requirement – but in light of the reference to 12 U.S.C. § 1790d(d), the requirement may be no higher than the risk-based capital threshold the agency has established for adequately capitalized credit unions.

As discussed below, 12 U.S.C. § 1790d(b)(1) provides that NCUA's PCA system must be consistent with Section 1790d and "comparable" to the system established under section 38 of the Federal Deposit Insurance Act. NCUA has followed the lead of the bank regulators in proposing a higher risk-based capital requirement for well capitalized credit unions, although the well capitalized risk-based capital ratio under Basel III is 10%, compared to NCUA's 10.5%.

While NCUA has been mindful of comparability, under 12 U.S.C. § 1790d(b) Congress also directed NCUA to develop a PCA system that takes into account the unique nature of credit unions. Specifically, NCUA is to consider that credit unions are not-for-profit cooperatives that do not issue stock, rely on retained earnings to build capital, and have volunteer boards of directors. By setting a higher risk-based capital requirement for well capitalized credit unions, the proposal fails to take these factors into account.

The conclusion that NCUA may not set risk-based capital standards for well capitalized credit unions that is higher than the threshold for adequately capitalized credit unions is also reinforced by the structure of the statute. Section 1790d(e) sets forth a specific mechanism under which "adequately capitalized" credit unions are required to continue building their capital so that they ultimately will satisfy the explicit standard that Congress adopted for classification as "well capitalized." Notably, Subsection 1790d(e)(2) provides NCUA with a specific role in that process and carefully defines its discretion, under which the agency may *decrease* but may *not increase* the rate at which "adequately capitalized" credit unions are required to augment their capital. Accordingly, this specific statutory mechanism for building capital confirms the natural interpretation of the literal language of Section 1790d, that Congress did not grant NCUA authority to adopt a second and higher risk-based net worth requirement for a credit union to be classified as well capitalized.

The legislative history of CUMAA clearly states that Congress delegated to the NCUA Board only the authority to adopt a single risk-based net worth standard for both "adequately capitalized" and "well capitalized" levels. Comment letters submitted to NCUA by former Speaker of the House Newt Gingrich and former Senate Banking Committee Chairman Alfonse D'Amato confirm that Congress acted deliberately to restrict NCUA to the issuance of a *single* risk-based capital requirement that would apply to both net worth categories.

NCUA did not offer a legal rationale for its proposed dual risk-based standards in its Notice of Proposed Rulemaking. The justification it has belatedly offered in letters to Congressmen Kenny Marchant and Steve Stivers violates the express language of CUMAA. While the specific substantive provisions of Section 1790d expressly authorize it to adopt only a single risk-based net worth standard, NCUA claims that it can import a dual risk-based net worth requirement into its regulation. The agency looks to Section 1790d(b)(1)(A)(ii), which provides generally that the agency's implementing rule shall be "comparable" to the PCA system applied to banks under 12 U.S.C. 1831o – a system that, through rules adopted by other administrative agencies, does contain two different risk-based standards for "adequately capitalized" and "well capitalized" institutions.

NCUA's position ignores the plain language of the statute. The provision immediately prior to the one on which it relies, Section 1790d(b)(1)(A)(i), provides that NCUA's regulation shall be "consistent with this section . . ." The rationale NCUA offered the Members of Congress in defense of the agency's position fails to acknowledge the existence of this provision, which expressly requires that the agency's implementing rule must comply with the specific provisions that Congress actually enacted in Section 1790d.

NCUA also simply ignores the existence of Section 1790d(e), a specific mechanism that addresses the same concerns – how to ensure that "adequately capitalized" credit unions continue to increase their capital so that they ultimately may qualify as "well capitalized" – that NCUA purported to resolve by importing the mechanism applicable to banks into the credit union system. The word "comparable" connotes a system that is "like or equivalent" to the system for banks, but not one that is identical in every respect. The requirement that the two systems be "comparable" cannot serve the function that would be necessary in order for NCUA's approach to be valid – that "comparable" serves as a trump card that allows the agency to overrule or disregard any part of Section 1790d that it wishes Congress had drafted differently, and thereby read the provisions Congress actually enacted out of the law.

A regulatory agency possesses only such authority as Congress actually delegated to it. *See FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000). The explicit language of Section 1790d, its structure, and its legislative history demonstrate that Congress granted NCUA only the authority to establish a *single* risk-based net worth requirement for a complex credit union to be classified as "adequately capitalized." Accordingly, were NCUA to issue a final rule adopting a second and higher risk-based standard for classification as "well capitalized," that provision would be highly vulnerable to being declared illegal as contrary to the unambiguous language of Section 1790d under the First Step of *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

1. The Rule Violates the Unambiguous Language of Section 1790d, Which Authorizes NCUA to Establish Only a Single Risk-Based Net Worth Requirement, Tied to Classification as "Adequately Capitalized"

a. <u>The Literal Language of the Statute</u>. The Proposed Rule would establish two separate risk-based capital standards to determine the sufficiency of a complex credit union's net worth. First, to be classified as "adequately capitalized," a credit union would have to have "a total risk-based capital ratio of 8.0 percent or greater." Proposed § 702.102(a)(2)(ii). Second, to be classified as well capitalized, a credit union would have to have "a total risk-based capital ratio of 10.5 percent or greater," or 2.5 % higher than the amount necessary to be classified as "adequately capitalized." Proposed § 702.102(a)(1)(ii).

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Insofar as the proposal purports to establish a second and higher risk-based net worth requirement for classification as "well capitalized," it is illegal as a matter of law. The language of Section 1790d is explicit and unambiguous. It authorizes NCUA to establish one, and only one, risk-based capital standard, which is tied to the requirement for determining whether a credit union is adequately capitalized.

Section 1790d(c) defines five "net worth categories" to be used in implementing the PCA program for complex credit unions. Two of those five categories are relevant here:

(1) In general

For purposes of this section the following definitions apply:

(A) Well capitalized

An insured credit union is "well capitalized" if –

(i) it has a net worth ratio of not less than 7 percent; and

(ii) it meets any applicable risk-based net worth requirement under subsection (d) of this section.

(B) Adequately capitalized

An insured credit union is "adequately capitalized" if –

(i) it has a net worth ratio of not less than 6 percent; and

(ii) it meets any applicable risk-based net worth requirement under subsection (d) of this section.

In each case, the language of paragraph (ii) of the definitions provides, in identical language, that the credit union's classification depends on whether it meets "any applicable risk-based net worth *requirement* under subsection (d)," utilizing the singular noun "requirement."

Section 1790d(d) in turn defines the "risk-based net worth requirement" that is incorporated into these definitions to determine a credit union's capital classification.

(d) Risk-based net worth requirement for complex credit unions

(1) In general

The regulations required under subsection (b)(1) of this section shall include a risk-based net worth *requirement* for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.

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(2) Standard

> The Board shall design the risk-based net worth *requirement* to take account of any material risks against which the net worth ratio required for an insured credit union *to be adequately capitalized* may not provide adequate protection.

The unambiguous language of both subsections (d)(1) and (d)(2) refers to a singular "risk-based net worth *requirement*." Congress initially considered utilizing the plural noun "requirements," and the House of Representatives did so in the version of the bill that it approved on April 1, 1998. But Congress subsequently chose to use the *singular* noun "requirement" to define the standard NCUA is authorized to establish in the version of the bill that was considered and approved by the Senate on July 28, 1998; considered and agreed to by the House of Representatives on August 4, 1998; and, signed into law by President Clinton three days later. Subsection (d)(2) further provides that the risk-based net worth "requirement" Congress authorized must take account of a single factor – any material risks against which the statutory 6 percent net worth standard ratio "required for an insured credit union to be *adequately capitalized* may not provide adequate protection." Congress thereby expressly tied the single risk-based net worth "requirement" NCUA is authorized to establish to the level of capital necessary for a credit union to be classified as "adequately capitalized."

NCUA's proposal to establish a second standard tied to classification as "well capitalized" thus violates the unambiguous language of the statute. Nothing in Section 1790d(d) empowers the agency to adopt a second, and higher classification standard.

b. The Structure of the Statute. The structure of Section 1790d further confirms that Congress authorized NCUA to establish only one risk-based net worth requirement, tied to the "adequately classified" level.

In Section 1790d(e), Congress adopted an explicit statutory mechanism that required "adequately capitalized" credit unions to increase the amount of retained earnings they held until they reached the "well capitalized" level. Congress also gave NCUA an explicit role to play in that process. The existence of this mechanism demonstrates that there is no justification for NCUA's effort to read into Section 1790d(d) a second and higher risk-based net worth requirement of its own creation that is nowhere mentioned in that provision and purportedly trumps the mechanism Congress adopted to compel "adequately capitalized" credit unions to raise additional capital.

Section 1790d(e) provides:

(e) Earnings-retention requirement applicable to credit unions that are not well capitalized

(1) In general

> An insured credit union that is not well capitalized shall annually set aside as net worth an amount equal to not less than 0.4 percent of its total assets.

(2) Board's Authority to decrease earnings-retention requirement

(A) In general

The Board may, by order, decrease the 0.4 percent requirement in paragraph (1) with respect to a credit union to the extent that the Board determines that the decrease –

(i) is necessary to avoid a significant redemption of shares; and

(ii) would further the purpose of this section.

In Section 1790d(e)(1), Congress requires credit unions classified as "adequately capitalized" to raise additional capital by setting aside each year a defined amount of retained earnings (not less than 0.4% of total assets) until it is classified as "well capitalized." Further, in Section 1790d(e)(2), Congress granted NCUA an explicit role to play in the process by which "adequately capitalized" credit unions would be required to raise additional capital. It empowers NCUA to *reduce* the annual rate at which an "adequately capitalized" credit union may be required to increase its capital. But this provision does not authorize NCUA under any circumstances to *increase* the rate at which an "adequately capitalized" credit union may be required to augment its capital.

The structure of Section 1790d thus further demonstrates that NCUA's effort to import from the bank PCA system a process for requiring "adequately capitalized" credit unions to increase their capital is illegal, because Congress already has adopted a specific but different statutory mechanism to address that very problem.

3. <u>The Legislative History of the Statute</u>. The legislative history of CUMAA confirms that Congress intended for NCUA to issue a single risk-based net worth requirement that is tied to the "adequately capitalized" classification, rather than to the "well capitalized" category.

The Senate Report which accompanied the measure states:

> New section 216(d) requires the NCUA, by regulation, to prescribe *a* risk-based net worth *requirement* for federal insured credit unions that are complex, as defined by NCUA.[1]

The Report thereby clearly demonstrates that Congress intended for NCUA to adopt a single risk-based standard. Moreover, the Report unambiguously states that Congress intended that this single risk-based net worth requirement would be tied to the definition of an "adequately capitalized" credit union, rather than to the classification of a "well capitalized" credit union.

> The NCUA must design the risk-based net worth *requirement* to take into account any material risks against which the 6 percent net worth ratio required for an insured credit

[1] S. Rep. No. 105-193, 105th Cong., 2d Sess. (May 21, 1998) at 14 (emphasis added).

> union to be adequately capitalized may not provide adequate protection. Thus, the NCUA should, for example, consider whether the 6 percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks.[2]

This conclusion is further strengthened by comments letters submitted to NCUA by two former Members of Congress, both of whom held senior leadership positions in the Chambers in which they served and were intimately involved in the crafting of CUMAA. In their comment letters, each former Member of Congress discusses how the PCA provisions authorize NCUA to adopt only a *single* risk-based net worth requirement, tied to the "adequately capitalized" classification. Former Speaker of the House Newt Gingrich wrote:

> I find NCUA's proposal extraordinarily troubling because it exceeds the agency's statutory authority. Under the proposal, NCUA would subject well capitalized credit unions to risk-based capital requirements that are 2.5% higher than those proposed for adequately capitalized credit unions. This is not what Congress contemplated NCUA should do to establish a Prompt Corrective Action regime. We never intended, nor even comprehended the possibility of, higher risk-based capital requirements for well capitalized credit unions than those that apply to adequately capitalized credit unions.
>
> We said as much [in Section 1790d(d)(2)]. It was our intent to direct NCUA to apply risk-based requirements for a credit union's capital at the adequately capitalized level . . .
>
> If Congress wanted a different result, we would have indicated that. In fact, in other banking statutes, we did exactly that.[3]

Similarly, Senator Alfonse M. D'Amato, Chairman of the Senate Banking Committee at the time CUMAA was enacted, stated that the proposed rule exceeds the authority Congress delegated to NCUA insofar as it "would apply a risk-based capital standard to determine whether a credit union is well capitalized." According to the then Senate Banking Committee Chairman:

> When we crafted the credit union version of PCA, we modeled it after the bank version already in place, but we incorporated some very important differences to reflect the different nature of banks and credit unions. In particular, we specified in the law the values of the net worth ratios required for a credit union to be either adequately and well capitalized. We purposely set these levels at 6% and 7%, which were higher than the thresholds then and still in place for banks, at 4% and 5%. Because of this higher pure net worth requirement for credit unions, we called for a different risk-based component in credit union PCA. Rather than the dual risk-based system then in place for banks, with a given risk-based capital ratio threshold to be adequately capitalized and a higher risk-based capital ratio threshold to be well capitalized, we instructed NCUA to construct only a risk-based net worth floor, to take account of situations where the 6% requirement to be adequately capitalized was not sufficient. . . . If we had intended there should also be a

[2] *Id.* (emphasis added).
[3] Letter dated May 23, 2014 from former Speaker of the House Newt Gingrich to the National Credit Union Administration commenting on NCUA's proposed Risk-Based Capital rule.

separate risk-based requirement to be well capitalized (in addition to the 7% net worth ratio), we would have said so.[4]

In sum, the legislative history reinforces the unambiguous language of Section 1790d itself, that NCUA has authority to issue only a single risk-based net worth requirement, tied to the criteria necessary for classification of a credit union as "adequately capitalized."

2. NCUA's After-the-Fact Legal Position Is Unlawful Because It Ignores the Plain Language of Section 1790d

As noted, NCUA did not offer a legal justification in its Notice of Proposed Rulemaking for its purported authority to establish a second, higher risk-based net worth requirement. The claim it belatedly has offered for its proposal ignores the unambiguous language and structure of Section 1790d.

As NCUA has recognized in its letters to Congressmen Marchant and Stivers, the governing provision is Section 1790d(d), which requires it to establish "a risk-based net worth requirement," is expressed in the singular. The agency then points to language in Section 1790d(b)(1), which states that its rule must be "comparable to" the PCA system for banks under Section 1831o. Since the system for banks contains different risk-based requirements for classification as "adequately capitalized" and "well capitalized," NCUA concludes that the "comparable to" language authorizes it to impose a dual risk-based capital system on credit unions.

NCUA's argument is fatally flawed. The agency has simply ignored another provision in Section 1790d(b)(1) that contradicts its interpretation and makes it unlawful. The relevant provision, Section 1790d(b)(1)(A), states:

> The Board shall, by regulation, prescribe a system of prompt corrective action for insured credit unions that is –
>
> (i) <u>consistent with this section</u>; and
>
> (ii) comparable to section 1831o of this title.

(Emphasis added)

NCUA's interpretation completely ignores the explicit statutory requirement in Paragraph (1)(A)(i) that its rules must be "consistent with this section [Section 1790d]." That provision is parallel to, and of equal force and effect as, Paragraph (1)(A)(ii), on which NCUA's entire argument rests. Paragraph (1)(A)(i) expressly states that the agency's rule must comply with the specific substantive requirements that Congress actually enacted in Section 1790d. NCUA's adoption of a dual-level risk-based capital ratio would be in direct conflict with the provisions Congress actually adopted which, as discussed above, expressly authorize only a single risk-based net worth requirement, at the adequately capitalized level.

[4] Letter dated May 7, 2014 from former Senate Banking Committee Chairman Alfonse M. D'Amato to the National Credit Union Administration commenting on NCUA's proposed Risk-Based Capital rule.

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The fatal error in NCUA's argument is apparent. Its entire rationale rests on the claim that inclusion of the general phrase "comparable to" in Paragraph (1)(A)(ii) allows it to ignore any provision of Section 1790d with which it disagrees and to import into the PCA system for credit unions any provision in the system for banks that it believes is preferable. Under standard dictionary definitions, the word "comparable" connotes a system that is "like or equivalent" to the system for banks, but not one that is identical in every respect. The word "comparable" cannot bear the extraordinary weight that would be necessary for NCUA's approach to be valid – to serve as a trump card that would allow NCUA to modify or disregard any part of Section 1790d that Congress actually adopted and grant itself authority to exercise any provision that Congress enacted in the PCA system for banks but excluded from the system for credit unions.

NCUA's construction therefore is illegal because it would read the provisions Congress actually enacted out of the law. Its approach also would violate two established canons of construction – that where there is not a clear expression of Congressional intent otherwise, a specific statute will not be controlled or nullified by a general one;[5] and that a statute should not be interpreted in a way that would render other provisions of the same act superfluous or unnecessary.[6]

In addition, NCUA's position completely ignores the existence and operation of Section 1790d(e), in which Congress adopted a specific mechanism by which "adequately capitalized" credit unions are required to generate additional capital over time to qualify as "well capitalized." This provision addresses the same problem that NCUA purported to solve through its dual risk-based capital system. The agency's approach, however, is inconsistent with the mechanism that Congress actually adopted to deal with this issue and cannot stand.

For these reasons, insofar as the Proposed Rule purports to establish a dual risk-based net capital system that would impose a different and higher net worth requirement for a complex credit union to be classified as "well capitalized" than to be categorized as "adequately capitalized," NCUA's approach is contrary to the express language of Section 1790d. Were NCUA so ill-advised as to adopt in its Final Rule the proposed dual-based capital standard approach that simply ignores the language of multiple parts of the statutory structure that Congress actually adopted, that provision would be highly vulnerable to being overturned as unlawful by a reviewing court.

[5] *Crawford Fitting Co. v. JT Gibbons, Inc.*, 482 U.S. 437, 445 (1987), quoting *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 153 (1976).
[6] *See e.g., Ratzlaf v. United States*, 510 U.S. 135, 141 (1994).

CUNA
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Filed via regcomments@ncua.gov
April 17, 2015

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: NCUA's Risk Based Capital Proposal, RIN 3133-AD77

Dear Mr. Poliquin:

The Credit Union National Association (CUNA) appreciates the opportunity to submit comments to the National Credit Union Administration (NCUA) Board's request for comments on the NCUA's second proposed-risk based capital rule (RBC2). By way of background, CUNA is the national trade association for America's state and federally chartered credit unions. CUNA represents approximately 90% of America's 6,500 credit unions and their 102 million memberships.

RBC2 represents an improvement over the original proposal NCUA issued last year, but it remains fundamentally flawed. It is a solution that will not work to a problem that does not exist. As we discuss below, NCUA has ignored its obligation to consider the cooperative nature of credit unions when creating a risk-based capital regime comparable to FDIC; CUNA continues to question NCUA's authority to establish a risk-based capital standard for the purposes of determining whether a credit union is well-capitalized; we feel NCUA has failed to satisfactorily demonstrate a compelling need for the proposal; we have serious concerns regarding the proposal's capital adequacy plans, risk-weights, and treatment of goodwill; we believe the proposed definition of complex credit union does not adequately reflect credit union complexity; we encourage NCUA to provide credit unions greater flexibility than what is proposed with respect to providing data on the Call Report; and we encourage NCUA to delay the implementation date until 2021. In addition, we have provided comments, as requested, on the need for additional interest rate risk (IRR) regulation and the use of supplemental capital for the purposes of this proposed rule.

I. NCUA Has Ignored its Obligation to Consider the Cooperative Nature of Credit Unions When Creating a Risk-Based Capital Regime Comparable to FDIC

One of the most troubling elements of the RBC2 proposal is the pervasive implication that credit union capital requirements, and also regulation and supervision, should be modified to be more like those applied to Federal Deposit Insurance Corporation (FDIC) insured institutions. The Federal Credit Union (FCU) Act does indeed require NCUA to establish a risk-based capital system that is comparable to that in place for FDIC insured banks; however, the Act also instructs NCUA to take into account the cooperative character of credit unions.[1] In drafting the proposal, the agency appears to have devoted itself to the comparability requirement, while ignoring the cooperative nature of credit unions.

This issue goes beyond the RBC2 proposal. A number of NCUA initiatives since the financial crisis appear driven by the view that NCUA's regulation and supervision of credit unions should mimic the practices and policies of the federal banking regulatory authorities.

But credit unions are not banks. Because of their unique cooperative structure, strong member focus, and the absence of stock options for executives or pressure from stockholders, these not-for-profit institutions with democratic governance eschew excessive risk taking.[2] Because credit unions take on less risk, they tend to be less affected by the business cycle, and therefore can serve as an important counter cyclical economic force in local markets, softening the blow of economic downturns in local economies. Indeed, in the face of the recent financial crisis credit unions – unlike their counterparts in the for-profit banking sector – served as *both* a counter-cyclical force *and* a safe haven, with much stronger loan and deposit growth than banking institutions.

If credit unions are regulated and supervised more and more like banks, they will act more and more like banks. That would be a tragic loss for the consumers of financial services in America's working and middle class.

II. NCUA Does Not Have the Statutory Authority to Establish a Risk-Based Capital Standard for the Purposes of Determining Whether a Credit Union Is Well-Capitalized

NCUA has proposed a risk-based capital regime that includes a higher risk-based capital requirement for a credit union to be well-capitalized than to the risk-based capital requirement for an adequately capitalized credit union, despite the fact that the FCU Act directs NCUA to connect risk-based requirements to the sufficiency of a credit union's net worth for the **adequately-capitalized classification only.**[3]

We have previously outlined our view that NCUA lacks the legal authority to implement a risk-based capital requirement for a credit union to be well-capitalized in our comment letter on the previous proposal (RBC1) and legal opinion provided to NCUA staff. This position is supported by several Members of Congress who were directly responsible for the development of this provision of the FCU Act and who commented on the previous proposal, including the former chairman of the Senate Banking Committee, who said:

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[1] 12 U.S.C. § 1790d(b)(1)(B).

[2] Edward J. Kane and Robert J. Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers*, Journal of Banking and Finance, 20 (September, 1996), pp. 1305-1327. Kane and Hendershott describe how the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.

[3] 12 U.S.C. § 1790d(d)(2).

> "[W]hen we included in the law the language: 'The Board shall design the risk-based net worth requirement to take account for any material risk against [which] the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection,' we meant just that, adequately capitalized. If we had intended there should also be a separate risk-based requirement to be well capitalized (in addition to the 7% net worth ratio), we would have said so."[4]

Given the preponderance of evidence which suggests that NCUA does not have the authority to establish a risk-based capital requirement for the purposes of determining whether a credit union is well-capitalized, we urge NCUA in the strongest terms possible to revise the proposal consistent with current law. If NCUA feels it needs the authority to establish a requirement for well-capitalized credit unions, it must go back to Congress and ask for the authority.

Even though CUNA continues to disagree that NCUA has legal authority to implement a two-tiered approach in RBC2, NCUA made improvements by lowering the threshold for a well-capitalized complex credit union from RBC1's proposed 10.5% to 10%. This remains well above the proposed 8% requirement for an adequately capitalized credit union. While this treatment is preferable to RBC1, we still have concerns that the new approach is inconsistent with the FCU Act for the same reasons stated in our RBC1 comment letter.

III. NCUA Has Failed to Demonstrate a Compelling Need for the Rule

In addition to the lack of a statutory footing for the proposal, there is virtually no evidence of the need for a revision of credit union capital standards, particularly one modeled on commercial bank Basel-style risk-based capital requirements. As Chairman Matz noted in her December 2011 letter to the Governmental Accountability Office, "consumer credit unions performed very well during the worst financial crisis since the Great Depression and NCUA was highly successful overall in mitigating failures and losses for consumer credit unions."[5]

The financial crisis that began in 2007 exposed the U.S. financial system to a perfect laboratory test of the adequacy of capital requirements and prudential regulation. A comparison of the performance of the two deposit insurance systems in the U.S., the National Credit Union Share Insurance Fund (NCUSIF) and FDIC during and after the financial crisis demonstrates that the credit union capital regime, as currently structured, is remarkably robust. The same is not true of the bank system, and that fact has led to substantial changes to the FDIC's funding and bank capital requirements. Those changes are entirely appropriate given the shortcomings exposed by the financial crisis. But similar shortcomings were not revealed for the credit union system, and there is therefore no case for NCUA to adopt any of the recent initiatives launched by the FDIC.

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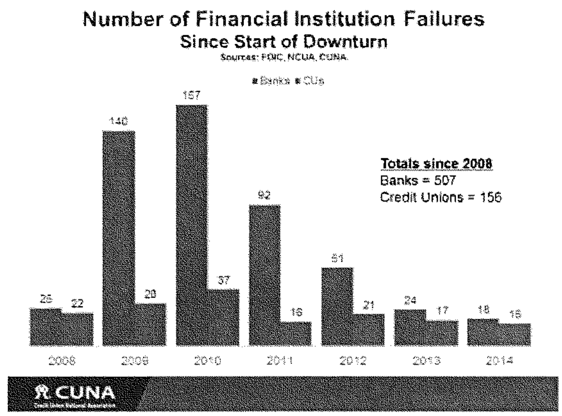
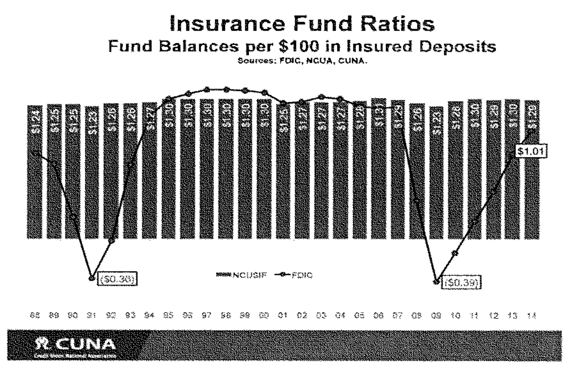
[4] Letter from Senator Alfonse M. D'Amato to Mr. Gerard Poliquin, Secretary of the Board, National Credit Union Administration. May 7, 2014.

[5] Letter from NCUA Board Chairman Debbie Matz to Ms. A. Nicole Clowers, Director Financial Markets and Community Investment, United States Governmental Accountability Office. December 19, 2011.



From 2007 to 2012, 465 commercial banks failed, and the FDIC's Deposit Insurance Fund (DIF), battered by insurance losses, fell into negative territory at -0.39% of insured deposits in 2009, despite combined premium assessments in 2008 and 2009 of 27 basis points[6]. Since then, with the help of additional assessments totaling 46 basis points, and reversals of previous insurance loss estimates, the DIF has recovered to 1.01% of insured deposits. Because of the stresses this episode placed on the DIF, Congress passed a number of FDIC reforms in the Dodd-Frank Act, and the FDIC board has adopted a policy of increasing the size of the DIF far beyond its previous level, which typically fluctuated in the range of 1.2% to 1.4% of insured deposits.



[6] Until the first quarter of 2011, FDIC levied premiums on "assessable deposits". Since then premiums have been based on "assets less tangible equity", roughly total deposits plus liabilities. Both of these assessment bases are larger than insured deposits.

The experience of the credit union system and its deposit insurance fund could not have been more different. Credit unions lived through the same severe financial crisis, but with strikingly different results. From 2008 to 2012 the NCUSIF fund balance never fell below its historical range of 1.2% to 1.3% of insured deposits, despite the failures of 124 credit unions. This stability in the fund ratio was accomplished with just two share insurance premiums, in 2009 and 2010, totaling 24 basis points of insured shares.

In other words, credit unions successfully navigated through the most severe economic catastrophe in modern economic times – and without the benefit of the proposed RBC regulations. During this episode, banks faired much worse operating under a Basel-style capital requirement system similar to the one being proposed for credit unions in the RBC2 proposal.

FDIC vs NCUSIF Performance (2008 – 2012)

	NCUA	FDIC
Deposit Insurance Fund Balance		
% of Insured Deposits		
Initial (2007)	1.29%	1.22%
Lowest (2009)	1.23%	-0.39%
Ending (2012)	1.29%	0.44%
Number of Failed Institutions	124	465
% of failures with > $100 million in assets	21%	79%
% of failures with > $50 million in assets	24%	92%
Total Insurance Premiums (bp)	24	73

Not only has the agency failed to demonstrate the need for the proposal, the risk-based structure it has proposed would do very little to reduce future insurance fund losses. This is because, by our analysis, it would not have noticeably reduced insurance losses during the recent crisis had it been in effect. The proposal states that 27 credit unions with assets greater than $50 million failed between 2008 and 2012 – costing the insurance fund $728 million.

Our analysis of the 26 credit unions with more than $80 million in assets just before the crisis (as of December 2007) that subsequently failed reveals that only seven would have had a lower capital classification under RBC2 than they in fact had under current rules. Six of the 21 well-capitalized credit unions under current rules would have been downgraded, four to being adequately-capitalized, and two to undercapitalized. One adequately-capitalized under current rules would have been classified as undercapitalized under RBC2. In other words, of the 26 failures, a total of just three would have been demoted to being undercapitalized by RBC2, and therefore subject to net worth restoration plans. And the amount of capital they would have been required to obtain to become adequately-capitalized is only $7 million, as compared to the insurance loss of over $700 million. Further, the amount of capital that would have been necessary for all seven downgraded credit unions to regain their previous capital classifications (six to well-capitalized, one to adequately-capitalized) would have totaled a mere $43 million.

Capital Classifications as of December 2007
of 26 Credit Unions that Subsequently Failed

	Current PCA System	RBC2	Change from Current to RBC2
Well Capitalized	21	15	Down by 6: 4 to adequate, 2 to under
Adequately Capitalized	2	5	Up by 3: 4 from well, 1 to under
Undercapitalized	2	5	Up by 3: 2 from well, 1 from adequate
Critically Undercap'd	1	1	No change
Total	26	26	19 no change, 7 to lower classifications

If a goal of a Prompt Corrective Action scheme is for covered institutions to hold sufficient capital to withstand a severe financial crisis without imperiling the deposit insurance fund, the results of the lab test that was the recent financial crisis are compelling evidence that a major overhaul of credit union capital requirements toward a Basel-style system is simply not required.

IV. The Proposed Capital Adequacy Plan Imposes Systemically Significant Financial Institution Stress Testing Requirements on Well-Capitalized and Significantly Smaller Credit Unions

Credit unions are understandably very concerned about NCUA's proposed additional provisions regarding capital adequacy. Potentially, these provisions could be among the most problematic for credit unions in RBC2 because they would grant examiners considerable latitude to determine whether a credit union needs more capital even if it is well-capitalized according to standard net worth and risk-based capital ratio requirements.

Under RBC2, complex credit unions would be required to develop a capital adequacy plan to assess the sufficiency of their capital on an ongoing basis, and set aside capital that is over and above the 7% net worth and 10% RBC requirements. The credit union's plan, assessment, and amount of additional capital set aside would all be subject to examiner review.

These requirements are not necessary for the vast majority of complex credit unions based on their management, risk profiles, and current levels of capital. If NCUA examiners have concerns regarding the credit unions they supervise, those situations should be addressed on an individual basis and not through rulemaking that would apply universal requirements to all complex credit unions, regardless of how well managed they may be. As we show elsewhere in this letter, credit unions and the NCUSIF have functioned well without these provisions and NCUA has not provided sufficient justification to support their imposition now.

In recognition of the unique characteristics of credit unions and their lower risk profile, Congress did not intend for credit unions generally to be subject to higher capital requirements than what the FCU Act directs. We reject the notion that the thresholds for a credit union to be well-capitalized as established by Congress are in any sense "minimum" capital requirements. If Congress had intended that to be the case, it would have described the classification as minimally capitalized. Well-capitalized means well-capitalized, plainly and simply. If a credit union meets the net worth and risk-based capital requirements to be well-capitalized, the sufficiency of its capital should not be an issue in terms of any rule that could require it to hold additional capital to be considered well-capitalized.

Even if NCUA had sufficient authority to establish higher capital requirements beyond thresholds that Congress authorized it to implement by regulation, a requirement for even more capital beyond what RBC2 anticipates would be overkill.

In light of these concerns, CUNA strongly opposes the capital adequacy plan requirements in RBC2. Strategic capital planning is very important for credit unions, and each credit union's long-term desired capital ratio will depend on the credit union's own assessment of the risks it faces, and its tolerance for risk. Such a plan, which for many credit unions includes a buffer of additional capital to stay above regulatory requirements, should not be the subject of examination and supervision, and the goals a credit union establishes for its own capital sufficiency should not become targets or standards for review in an examination.

CUNA urges NCUA to delete the capital adequacy provisions from the RBC2 proposal.

V. The Definition of Complex Should Be More Complex Than An Asset Threshold Which is Much too Low

Like its predecessor, RBC2 would use asset size as a proxy for complexity, leaving us with the same concerns about the definition of "complex" as we detailed in our RBC1 comment letter. Size should not be the only determinant for whether RBC requirements apply. Raising the asset size from $50 million to $100 million does, however, improve a flawed definition simply by impacting fewer credit unions. While we agree that the $50 million level was far too low for the rule's threshold, $100 million is not the appropriate cut-off for application of the rule either.

As we stated in our comment letter last year, the FCU Act says NCUA should define "complex" based on the "portfolios of assets and liabilities of credit unions." It is unclear why NCUA is not following this direct instruction from Congress and is concentrating only on the size of a potentially complex credit union. If Congress had wanted the application of the PCA rules to be based on asset size, it simply would have required that NCUA use asset size to determine which credit unions fall under the requirements.

To be more consistent with the FCU Act, we recommend that NCUA increase the proposed $100 million threshold to $500 million and that the threshold be used in combination with actual operational complexity as measured by the agency's Complexity Index. Thus, we propose that all federally insured credit unions with assets of $500 million or under be excluded from the definition of "complex" and that only those credit unions with assets above $500 million and that have an NCUA Complexity Index (discussed in the Supplementary Information to RBC1) value of 17 or higher be required to meet risk-based capital provisions.

There is little danger to the credit union system with "complex" being defined as credit unions with $500 million or more in assets because two-thirds of NCUSIF insured shares are in these credit unions. NCUA would still have the authority to adjust the definition to include more credit unions in the future if the determination is made through the annual one-third regulation review that an insufficient amount of credit union assets are covered by RBC2. A measured approach would ensure that the proper number of assets eventually fall under RBC requirements. The burden will be lower using a $500 million threshold because fewer credit unions would initially be subject to RBC requirements. Subsequently expanding the threshold, if necessary, is less costly and burdensome than starting off applying the requirements to such a high number of credit unions.

As with any requirement based on a number that increases with inflation and the general growth of any industry, whatever number that NCUA chooses to define "complex" should be indexed. In addition, consistent with the current practice, any credit union that is identified as "complex" by NCUA should be able to present evidence to the agency as to why it is not complex and thus, should not be subject to risk-based capital requirements. The process for contesting an agency designation of "complex" should also be detailed in the final rule.

NCUA should provide a better tailored definition of "complex" to ensure that the only credit unions covered are those with activities that pose extraordinary risk, beyond routine loans and investments, for which their adequately-capitalized-level net worth does not provide adequate protection. This approach is consistent with the FCU Act and will result in a more reasonable application of risk-based capital requirements than relying on asset size alone to determine whether the definition of 'complex" has been met.

VI. NCUA Should Better Calibrate RBC2's Risk Weights

RBC2 makes a number of positive changes to RBC1's proposed risk weightings. Improvements include the removal of weighted average life components from risk weights for investments and changes to risk-weight escalation for higher concentrations of real estate and member business loans. Other examples of improved treatment under RBC2 include the designation of 1-4 family non-owner occupied mortgage loans as residential loans, subject to lower risk weightings than if NCUA had categorized the loans as member business loans. Unfortunately, RBC2's risk weights remain too high in key areas, given credit unions' level of risk, and they should be lower than what the federal bank regulators require for assets such as mortgage loans, member business loans, servicing and certain investments. Lower risk weightings for credit unions are appropriate given their different incentives to manage risk as compared to banks, and lower loss history as detailed in our comment letter on RBC1.

Specifically, current first lien residential mortgage loans over 35% of assets would have a risk weight of 75%, actually higher than the 50% risk weight for banks. Current and non-junior real estate loans over 20% of assets would also have higher risk weights than provided for banks. Also, credit union commercial loans over 50% of assets would have a risk weight of 150% while the weighting for bank commercial loans over 50% of assets could be as low as 100%. These risk weights should be adjusted downward to levels no more than those in place for banks as credit unions certainly do not have higher levels of risk associated with holding these assets. Lowering risk weights for higher concentrations of real estate and commercial loans would imply lower risk weights for lower concentrations of these loans compared to bank risk-weights, but this is entirely appropriate given lower loss rates at credit unions.

We support the proposed treatment of consolidated credit union service organization (CUSO) investments and loans in which no separate risk weighting would apply. The risk weight for unconsolidated CUSO investments, though, is still too high and should be the same as for CUSO loans, which is 100% under RBC2.

In addition, we believe the 250% risk weighting for mortgage servicing, which was unchanged from the first proposal and is the same as for banks, is too high and should be significantly lower in any final RBC2.

CUNA also does not support the 300% risk weighting for publicly traded equity investments which should be much lower so that credit unions will not be unduly limited in their investments for employee benefit funding. We also urge NCUA to assign a risk weight of no more than 100% to charitable donation account investments to help encourage credit unions to continue supporting charitable endeavors, such as the National Credit Union Foundation.

We are also concerned about the definition of the Mortgage Partnership Finance (MPF) Program.[7] As proposed, the definition could be construed as limiting the benefits of the risk based capital treatment only to those credit unions that service their MPF loans, but not those that choose to sell the loans servicing-released. Whether or not credit unions service their mortgage loans does not alter their credit enhancement obligation in any way. We urge NCUA to remove the words, "and servicing them" from the definition of the MPF Program. We also recommend adding language to clarify that the definition of the MPF Program does not apply to the Mortgage Purchase Program (MPP), a secondary market alternative offered by certain Federal Home Loan Banks that achieves credit enhancement by creating a contingent asset for the credit union participant, in contrast to the contingent liability obligation created under the MPF Program. Since the purpose of the risk based capital requirements for off-balance sheet activities is to ensure credit unions hold capital against recourse risk, and MPP loans do not have such risk, MPP loans should fall outside of the definition of the MPF Program.

VII. The Treatment of Goodwill and Other Intangible Assets Needs Additional Improvement

In the original proposal, goodwill and other intangible assets (OIA) would have been excluded from the numerator of the risk-based capital ratio. In RBC2, a subset of goodwill and OIA could be retained in the numerator of the RBC ratio until 2025. That subset would be limited to goodwill and OIA that arise from "supervisory" mergers prior to one month after

[7] 80 FR 4429-30.

publication of the final rule. Supervisory mergers would be broadly defined as assisted mergers, emergency mergers, or mergers where the NCUA or state supervisory authority selected the surviving credit union.

The retention of goodwill and OIA in the RBC numerator until 2025 is an improvement over the original proposal, but does not go nearly far enough. CUNA believes a strong case can be made for the inclusion of all goodwill and OIA in the numerator so long as these intangible assets meet Generally Accepted Accounting Principles (GAAP) requirements, i.e., are subjected to annual goodwill impairment testing. The exclusion of non-supervisory goodwill from the numerator will discourage some well managed and well-capitalized credit unions from participating in mergers, and many mergers serve to benefit the members of both the surviving and non-surviving credit union. Similarly, mergers can also have a favorable influence on safety and soundness – producing institutions that in combination have stronger financials and are able to weather more extreme economic swings. In some cases such mergers undoubtedly serve to head off what might ultimately become a supervisory combination.

In recognition that goodwill and OIA may not be available to cover losses in the event of a liquidation, but also accounting for the fact that GAAP goodwill is very unlikely itself to cause a credit union to fail, as an alternative, the final rule might limit the retention of non-supervisory goodwill and OIA in the numerator of the RBC ratio for those credit unions that are well capitalized on the basis of the net worth ratio.

At a minimum going forward non-supervisory goodwill that meets annual impairment testing should be retained in the numerator over a ten-year phase out period. In other words, after any future merger, the amount of any resulting goodwill or OIA that could be included in the numerator of the RBC ratio would be reduced by one tenth each year for ten years.

Regardless of whether or not non-supervisory goodwill is permitted in the numerator, CUNA strongly believes that all previous supervisory goodwill should be grandfathered without time limit, subject to regular impairment testing. There are three reasons for this. First, those credit unions that engaged in such transactions almost certainly reduced insurance losses to the share insurance fund, and should not be penalized after the fact. Second, they did so with an understanding of current rules at that time. Many of these transactions would likely not have occurred had the proposed rules been known, i.e., no longer counting this goodwill at some point in the future would be changing the rules midstream. Finally, the amount of previous supervisory goodwill is a known, fixed, and relatively small quantity. Only 20 credit unions with more than $100 million in assets have goodwill amounting to more than 5% of net worth, and the average goodwill to net worth ratio at these credit unions is just 12.8%. Supervisory goodwill likely represents no more than three quarters of that goodwill, i.e., approximately 10% of net worth. Considering future growth, that supervisory goodwill will decline in proportion to net worth and assets going forward, and grandfathering it would protect those credit unions that in the past reduced NCUSIF resolution costs, from a cliff reduction in their RBC ratios in the future.

VIII. NCUA Should Give Credit Unions an Option to Provide the Additional Call Report Information Required by RBC2

The proposed rule will require several changes to the Call Report in order to collect information on a number of new data elements provided in the proposal. The proposed changes will require credit unions to provide more detail regarding information that is presently reported on the Call Report and to provide new information that presently is not required.

While CUNA does not oppose the proposed additional data collection through the Call Report, we urge NCUA to consider an alternative to making changes that will affect all reporting credit unions. Specifically, we ask NCUA to consider an approach where credit unions will have the *option* of providing the additional, detailed information provided in the proposal. Such an approach could be accomplished by simply including additional optional data fields within the Call Report. It is our understanding that FDIC employs such an approach and we ask NCUA to consult with its fellow regulators for insight into an alternative to the current proposed changes to the Call Report.

In the Supplemental Information to the proposal, NCUA states that, "The Call Report changes prompted by this proposed rule are the kind that would easily be handled as part of the normal and routine maintenance of a credit union's data reporting system." We encourage NCUA to recognize that any and all changes required of a credit union require the expenditure of resources. In a time when many credit unions are struggling to comply with existing rules from NCUA and other regulators, we urge NCUA to consider any alternatives that will reduce the burden RBC2 will impose.

IX. NCUA Should Permit the Use of Supplemental Capital for the Purposes of this Proposal and Should Strongly Advocate for Statutory Capital Reform that Includes Supplemental Capital for the Purposes of Prompt Corrective Action

In our comment letter on RBC1, CUNA urged NCUA to allow the use of supplemental capital for any complex federally insured credit union to meet its RBC requirements. As discussed below, NCUA has the authority to permit supplemental capital for RBC purposes, and we believe NCUA should include such a provision if a final RBC2 rule is approved.

While supplemental capital cannot be included in net worth for most credit unions without a change in federal law, there is nothing in the FCU Act or GAAP that prevents NCUA from including supplemental capital in the numerator of the risk-based capital ratio for RBC, which already includes items that are not part of net worth.

We do not think NCUA needs to be overly prescriptive in permitting supplemental capital for RBC purposes. NCUA has already authorized certificates of indebtedness, which have been treated as loans from holders to their credit unions, generally with an interest rate paid to the holders. NCUA should reference the use of these instruments to meet RBC requirements for federal credit unions and, where permitted, for state chartered credit unions. Adequate disclosures should be provided by the credit union to the holder before the proceeds are accepted, but the timing or content of the disclosures need not be complicated. The disclosures should be clear and simple, to help ensure the members' interests are protected and should focus on plainly describing the nature and terms of the instruments. In addition, suitability requirements may be appropriate.

Further, we strongly encourage NCUA to aggressively pursue the enactment of legislation that would authorize the use of supplemental capital as net worth for the purposes of prompt corrective action. We note NCUA has long supported such legislation and we encourage the Board to actively advocate for its enactment.

X. A Separate Interest Rate Risk Rule Is Unnecessary Because Examiners Have Sufficient Tools to Supervise Interest Rate Risk

NCUA's revised RBC proposal contains what is essentially an implied Advance Notice of Proposed Rulemaking (ANPR) on interest rate risk (IRR)—suggesting that a separate IRR rule is needed. NCUA believes such a standard should be based on a comprehensive balance sheet measure, like net economic value, that takes into account offsetting risk effects between assets and liabilities (including benefits from derivative transactions). The stated intent of this measure would be to assess IRR consistently and transparently across all asset and liability categories, to address both rising and falling rate scenarios, and to supplement the supervisory process with a measure calibrated to address those institutions deemed by supervisory authorities to be severe outliers.

CUNA strongly disagrees with the notion that a separate IRR standard is needed to reasonably account for IRR at credit unions. Over the last several years, NCUA has issued numerous rules and letters addressing the issue of interest rate risk. For example, on September 30, 2012, the NCUA Board's final interest rate risk rule took effect. The rule imposes different requirements on federally insured credit unions depending on their asset size. Such requirements include the development and adoption of a written policy on IRR management and a program to effectively implement that policy as part of their asset-liability management responsibilities.

The guidance provided in the appendix to the IRR rule describes best practices for credit unions to consider as they write their IRR policy and construct IRR management programs. It deals with the responsibilities of boards and management, addresses IRR measurement and monitoring, internal controls, and the integration of IRR results into a credit union's decision making. The guidance also provides additional considerations if a credit union is large with complex or high-risk balance sheets. This alone should be the basis of NCUA's efforts to manage IRR concerns.

There is absolutely no need to burden the overwhelming majority of credit unions—those that are clearly not severe IRR outliers—with a new and complicated one-size-fits-all IRR approach. Instead, NCUA's focus should be squarely on the exceedingly small number of institutions that might be considered severe outliers. NCUA can easily identify severe outliers in the supervisory process—and undoubtedly has done so already. Due to the unique issues that cause each institution to be viewed as severe outliers, NCUA should concentrate resources on them separately in the supervisory process.

To this end we suggest that NCUA—prior to releasing a proposed IRR rule—form an advisory group consisting of a broad cross-section of credit unions. This advisory group should be tasked with developing a call-report-based "severe outlier identifier model." Using mostly existing call report data, the model would serve as an identification tool that evaluates each credit union's assets, liabilities, and all hedging positions that assist in managing risk exposures. Any credit union that "passes" using the model's identification rubric would be deemed to have only low-to-moderate IRR exposure and would not be subject to a standard comprehensive balance sheet model in the supervisory process. In these cases, each credit union's existing approach to IRR would be considered totally sufficient. As noted above, we expect the overwhelming majority of complex credit unions would not be selected by the designated model.

Importantly, a credit union that fails to pass using the tool's selection rubric would automatically be viewed as a "potential severe outlier." In these cases, the identification model would simply raise a "yellow flag" – requiring more detailed analysis and dialogue with supervisory authorities within the examination process. In essence this would be a resource allocation tool which would engage NCUA's Capital Markets/ALM specialists who would more closely evaluate each potential severe outlier.

Following this interaction an even smaller net number of actual "severe outliers" would be identified. These credit unions could be subjected to varying degrees of enforcement actions until they no longer were identified as severe outliers, or otherwise demonstrated to examiners that their interest risk was appropriately measure and managed.

This approach would be consistent with that which has been adopted by the banking regulators. As noted in our original comment letter, the banking industry's Basel requirements use a "three pillars" approach. Banking regulators address IRR in the "second pillar"—within the supervisory review process—in recognition of the fact that IRR is best addressed through policies, procedures and robust measurement systems. Banks are not subject to a standardized, quantified IRR rule—instead bank regulators essentially use the supervisory process to identify institutions of particular concern.

In any case, complex credit unions should not to be subject to layers of new IRR regulation disproportionate to their exposure to this risk.

It bears repeating—as noted in our previous comment letter—history has shown that credit union exposure to IRR is modest and credit unions have an enviable record of astute IRR management, continually demonstrating their ability to adequately manage, monitor and control such risk. For example, at the beginning of 2004, one-third of all credit unions with $50 million or more in total assets reported a Net Long-Term asset ratio exceeding 30% of total assets. In all, 170 of these credit unions reported a ratio between 40% and 50% of total assets and 83 reported a ratio that exceeded 50% of total assets.

Beginning in June of 2004 the Federal Reserve began to raise its short-term interest rate target and by July 2006 the Federal Funds interest rate had increased by roughly 425 basis points to a monthly average of 5.24%.

Despite this substantial market interest rate shock, we are unable to identify—either through material loss reviews (MLRs) or by other means—any strain on the NCUSIF caused by natural person credit union exposure to IRR. The NCUSIF ratio actually increased over the period from $1.27 per $100 in insured shares at the start of 2004 to $1.31 per $100 at year-end 2006. Similarly, we are unable to identify any natural person credit union with over $50 million in assets that failed as a result of too-high exposure to IRR.

XI. Implementation Should Be Delayed to 2021 to Coincide With the Termination of the Corporate Stabilization Fund

We appreciate that NCUA has proposed a significant delay in the implementation of RBC2, but we encourage the agency to delay implementation even further—until 2021—to coincide with the termination of the corporate stabilization fund, at which time credit unions will receive refunds. The refunds will be important to those credit unions that will need to increase capital levels in order to comply with RBC2.

XII. Conclusion

On behalf of America's credit unions and their members, thank you very much for the opportunity to provide comments on this proposed rule. As stated, we believe the proposal is fundamentally flawed and, in certain areas, exceeds NCUA's statutory authority. We urge NCUA to withdraw the proposal and, in lieu of that, we strongly encourage NCUA to make substantial improvements to the proposal consistent with our comments herein.

Sincerely,

Jim Nussle

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA®

July 23, 2015

Congress Should Exercise Vigorous Oversight of NCUA's Sweeping MBL Proposal

On behalf of the more than 6,000 community banks represented by ICBA, thank you for convening today's hearing on the National Credit Union Administration's Operations and Budget. ICBA is pleased to submit this statement for the record which sets forth our strenuous objections to the NCUA's recently published proposal to comprehensively rewrite the rule governing credit union member business lending.

Member business lending is a highly contentious issue which has been debated in Congress for more than a decade. The NCUA should not be permitted to end-run Congress with a proposal to significantly expand member business lending and other forms of credit union commercial lending and discard or weaken critical prudential safeguards. What's worse, certain provisions of the proposal clearly circumvent the plain language of the Federal Credit Union Act. ICBA's objections to the NCUA proposal include:

- **Flouting the statutory cap on member business loans.** The Federal Credit Union Act's statutory calculation clearly and unambiguously sets the member business lending (MBL) cap at 12.25 percent of assets. However, the NCUA MBL proposal, together with their proposal to apply risk based capital standards under Basel III to credit unions, could be used to circumvent the 12.25 percent MBL cap, raising it to 17.5 percent of assets or even higher for certain credit unions. This proposal simply cannot be squared with the plain language of the Act. According to the legislative history, the current MBL cap effects the will of Congress that credit unions serve persons of modest means "through an emphasis on consumer rather than business loans."[1] The legislative history also states that the MBL cap is intended to limit the risk of taxpayer losses as a result of "large commercial loans" by credit unions.

- **Taking "member" out of member business loans.** Under the current rule, the borrower – a credit union member – must personally guarantee a member business loan. This is what makes a loan a *member* business loan. Nevertheless, the proposal would remove the member guarantee requirement. A member business loan would become an ordinary business loan – a radical departure from the credit union lending model clearly not intended by the Federal Credit Union Act.

[1] According to the Senate Banking Committee Report accompanying 1998 Credit Union Membership Access Act (Senate Report 105-193), "Those restrictions [the 12.25 percent of assets MBL cap] are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, **through an emphasis on consumer rather than business loans.**

- **Undermining the MBL cap.** The current MBL cap already contains a number of exceptions that undermine its purpose and integrity. For example, whole loans and loan participations purchased from other credit unions do not count toward the cap. The NCUA proposal would greatly expand this loophole by removing the requirement that credit unions seek a waiver for such lending. This would allow large credit unions to engage in hundreds of millions and possibly billions of dollars of business loans outside of the MBL cap.

- **No analysis showing economic need.** The NCUA has failed to show economic need exists to justify its sweeping proposal. A recent survey published by the National Federation of Independent Businesses found that only four percent of small business owners reported not having **all** of their credit needs met, a historically low percentage.[2] In addition, only two percent of small businesses reported that obtaining credit was their main problem. Under these credit conditions, the NCUA proposal is unlikely to result in net new loans. Rather, it would allow tax exempt credit unions to siphon business loans from taxpaying community banks. This in turn would reduce tax revenues at the federal, state, and local levels.

- **Reckless weakening of prudential protections.** The NCUA proposal would discard or significantly weaken a series of prudential restrictions on member business lending such as loan-to-value caps on collateral used to secure loans and loan-to-a-single-borrower limits, as well as the borrower guarantee requirement noted above. As discussed below, this weakening of lending standards is completely unwarranted by credit unions' dismal record of failed member business loans.

In the background to the proposal, the NCUA itself concedes that: "Poorly managed business lending activities were a contributing factor in the failure of at least five credit unions since 2010. They account for roughly $141 million, or 25 percent of total share insurance fund losses over the last five years." Elsewhere, the NCUA has stated that MBLs are delinquent at 2.5 times the rate of all loans, and imprudent business lending has led to the weakening or failure of hundreds of credit unions.[3]

The NCUA should answer the question why, given its frank lack of confidence in credit union business lending, it proposes to weaken critical prudential safeguards. Reckless business lending has already jeopardized the credit union system. Credit unions lack the experience and the expertise to safely conduct business lending, and the NCUA lacks experience in supervising business lending.

Congress should oversee critical policy changes at the boundary between taxable and tax exempt institutions. ICBA hopes that this hearing will give committee members an opportunity to question the NCUA regarding the statutory authority and policy rationale for its proposal. A list of suggested questions is attached to this statement. A sweeping rewrite of MBL powers should not be made by regulatory fiat.

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[2] "Small Business Economic Trends." National Federation of Independent Businesses. May 2015.
[3] Testimony of Deborah Matz, Chairman, National Credit Union Administration, before the Senate Banking Committee, December 9, 2010.

Finally, ICBA believes the comment period on the NCUA proposal should be extended to allow additional time for public consideration and comment. As the NCUA concedes, the proposal would make "substantial changes" to credit union business lending procedures. The agency should have the benefit of a comprehensive and thoughtful public examination of its many consequential changes. An extension of 60 days or more would be appropriate and would allow Congress to review the proposal when members are in Washington D.C. Policy making of this significance should be conducted in the light of day, not during an August congressional recess.

Attachment

Questions for Chairman Matz regarding the NCUA MBL proposal

Questions for NCUA Chairman Matz

1) How much do you project credit union business lending will increase over the next 5 years if your proposal becomes a final rule?

2) What economic analysis has NCUA conducted to indicate there is a need for a massive increase in credit union business lending?

3) What percentage of new loans made under this proposal, if finalized, would be new business loans that would not otherwise have been made versus loans taken off the books of commercial banks?

4) How does NCUA monitor the mission of credit unions to ensure that credit union loans are being directed towards borrowers of "modest means" – consistent with the credit union mission? How would loans to borrowers of modest means be monitored under this new rule?

5) Could this proposed rule allow credit unions to have a MBL cap significantly higher than 12.25% (i.e., 17.5%)? If so, doesn't this conflict with current law which requires the MBL cap to be based on 1.75 times actual net worth or 1.75 times minimum net worth required for the credit union to be well capitalized? Please explain.

6) If participation loans and the purchase of whole loans are exempt from the MBL cap, does this incentivize large credit unions to buy or participate in large volumes of business loans with the nation's largest banks? If so, is this a loophole around the MBL cap?

7) The proposal indicates there have been approximately 1,000 waivers granted to credit unions over the past couple of years from business lending constraints. Can you explain the waiver review process and indicate under what circumstances NCUA grants waivers? What percentages of the waiver applications have been approved and what percentage have been denied?

8) The NCUA Board has acknowledged that this rule is a "significant change" and plans to allow an 18 month implementation period. Given the significant changes involved, shouldn't the comment period be 90 to 120 days?

July 23, 2015

The Honorable Richard Shelby
Chairman
Senate Banking Committee
Washington, DC 20515

The Honorable Sherrod Brown
Ranking Member
Senate Banking Committee
Washington, DC 20515

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Committee
Washington, DC 20515

Dear Chairmen Shelby and Hensarling and Ranking Members Brown and Waters:

The undersigned organizations, representing the 53 State Bankers Associations from every state in the country, write to strongly urge you to hold the credit union industry accountable and to significantly increase your oversight authority over the National Credit Union Administration (NCUA). NCUA is charged with protecting the safety and soundness of credit unions, but has turned into a cheerleader for the $1 trillion tax exempt industry it is charged with supervising.

We are deeply troubled by the actions and recent comments from NCUA's Chairman that, in the name of "regulatory relief," the agency is prepared to essentially provide the credit union lobby's legislative agenda through regulation despite Congress' repeated unwillingness to do so directly. For example, in June, NCUA proposed expansive changes to its business lending regulations, claiming authority to raise the Congressionally-imposed cap on business loans. The proposal also effectively makes the cap irrelevant through changes to loan participations, threatening safety and soundness and diverting credit unions from their mission of serving consumers.

NCUA's Chairman also said in a June 25, 2015 speech that the agency is on the verge of proposing regulations to water down the statutory prohibition on supplemental forms of capital and limitations on credit union fields of membership. Both would fuel substantial growth in the tax-exempt credit union industry, making a mockery of any concept of serving a targeted market. Even more brazenly, NCUA's Chairman also took credit in the same speech for freeing nearly *half of all credit unions* from statutory limitations on business lending, supplemental capital, and the acceptance of non-member deposits from any source through "streamlining" qualification for a designation designed to serve low-income people. With so many credit unions qualifying, we question whether NCUA could possibly be giving each institution a serious look at whether this special designation is appropriate. This is evidenced by some of the credit unions that have earned the status: one that serves residents of one of America's wealthiest communities, Stamford, CT, and others that serve America's wealthiest universities, including Harvard and Georgetown.

"Regulatory relief" does not mean promoting explosive growth of the credit union industry at the expense of taxpayers, community banks, or the communities those banks serve. Credit unions enjoy a massive $25.39 billion federal subsidy over 10 years in the form of the tax exemption. **These proposed changes would exponentially expand that tax subsidy while creating significant safety and soundness concerns, and should call into question whether the 81 year-**

old tax exemption is appropriate in the modern era. They certainly call into question the adequateness of the NCUA. We call on Congress to hold the credit union industry and the NCUA accountable and do everything possible to rein in this out-of-control agency.

Sincerely,

Alabama Bankers Association
Alaska Bankers Association
Arizona Bankers Association
Arkansas Bankers Association
California Bankers Association
Colorado Bankers Association
Connecticut Bankers Association
Delaware Bankers Association
Florida Bankers Association
Georgia Bankers Association
Hawaii Bankers Association
Heartland Community Bankers Association
Idaho Bankers Association
Illinois Bankers Association
Illinois League of Financial Institutions
Indiana Bankers Association
Iowa Bankers Association
Kansas Bankers Association
Kentucky Bankers Association
Louisiana Bankers Association
Maine Bankers Association
Maryland Bankers Association
Massachusetts Bankers Association
Michigan Bankers Association
Minnesota Bankers Association
Mississippi Bankers Association
Missouri Bankers Association
Montana Bankers Association
Nebraska Bankers Association
Nevada Bankers Association
New Hampshire Bankers Association
New Jersey Bankers Association
New Mexico Bankers Association
New York Bankers Association
North Carolina Bankers Association
North Dakota Bankers Association
Ohio Bankers League
Oklahoma Bankers Association
Oregon Bankers Association
Pennsylvania Bankers Association
Puerto Rico Bankers Association
Rhode Island Bankers Association
South Carolina Bankers Association
South Dakota Bankers Association
Tennessee Bankers Association
Texas Bankers Association
Utah Bankers Association
Vermont Bankers Association
Virginia Bankers Association
Washington Bankers Association
West Virginia Bankers Association
Wisconsin Bankers Association
Wyoming Bankers Association

cc: Members of the Senate Committee on Banking, Housing and Urban Affairs
Members of the House Committee on Financial Services

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Carrie R. Hunt
Senior Vice President of Government Affairs
and General Counsel

July 22, 2015

The Honorable Randy Neugebauer	The Honorable Wm. Lacy Clay
Chairman	Ranking Member
Subcommittee on Financial Institutions and Consumer Credit	Subcommittee on Financial Institutions and Consumer Credit
House Financial Services Committee	House Financial Services Committee
U.S. House of Representatives	U.S. House of Representatives
Washington, D.C. 20515	Washington, D.C. 20515

Re: Tomorrow's Hearing: "National Credit Union Administration Operations and Budget"

Dear Chairman Neugebauer and Ranking Member Clay:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the federal interests of our nation's federally-insured credit unions, I write today in conjunction with tomorrow's subcommittee hearing entitled "National Credit Union Administration Operations and Budget." NAFCU thanks you for holding this important hearing for the credit union industry and would like to take the opportunity to share our thoughts on some of our top concerns with the National Credit Union Administration (NCUA) ahead of the hearing. NAFCU believes that a robust discussion of credit union issues only helps to strengthen the industry.

NCUA's Budget

NCUA is funded by the credit unions it supervises. Each year, credit unions are assessed a different operating fee based on asset size. NCUA then pools the monies it receives from credit unions and uses those funds to create and manage an examination program. The monies that NCUA collects, however, have significantly increased since 2008 to cover more than $100 million in growth in the agency's annual operating budget which stands at $279 million today.

Because NCUA's budget is funded exclusively by the credit unions it regulates and insures, it is of the utmost and ever-increasing importance to the credit union industry. Yet, for the fifth year in a row, NCUA released and approved its annual budget without a formal hearing, thereby depriving the credit union industry and its membership, from which the agency receives its total funding, of the opportunity to formally comment on the agency's budget.

From 2001-2008, the agency held annual budget hearings to help promote transparency and allow the industry to ask questions to become better informed about NCUA's budget and the agency's plans for the year ahead. These hearings stopped in 2009, which happens to coincide with when the NCUA budget started to see significant increases. While this may have been expected during the financial crisis, these increases have continued post-crisis at a time when the FDIC has actually been scaling back its budget.

NCUA is charged by Congress to oversee and manage the National Credit Union Share Insurance Fund, the Temporary Corporate Credit Union Stabilization Fund, the Central Liquidity Fund, and its annual operating budget. Because these funds are comprised of monies paid by credit unions, NAFCU has long advocated the agency to exercise greater transparency by releasing non-aggregated balance sheets for each fund. Currently, NCUA publicly releases general financial statements and aggregated balance sheets for each of these funds. However, the agency does not provide non-aggregated breakdowns of the components that go into the expenditures from the funds. Although NCUA releases a plethora of public information on the general financial condition of the funds, they fail to fully disclose the amounts disbursed and allocated for each fund. NAFCU believes that credit unions deserve clearer disclosures of how the fees they pay the agency are managed.

Bipartisan legislation, H.R. 2287, the *National Credit Union Administration Budget Transparency Act* is pending before the committee. This legislation would require the NCUA Board, before the annual submission of its required detailed business-type budget, to: (1) print a draft of the budget in the Federal Register; (2) hold a public hearing to receive comments from the public on the draft; and (3) include in the required integral set of accounts statements in which the budget will address any of such comments. NAFCU urges you to support this legislation.

NCUA's Risk-Based Capital Proposal

In January of 2014, the NCUA Board initially proposed a risk-based capital system for credit unions. The proposal drew over 2,000 comments and over 360 Members of Congress expressed concerns. Based on those comments and concerns, the NCUA Board issued, by a 2-1 vote, a revised risk-based capital proposal in January of 2015. This revised proposal drew a record 2,167 comments and remains controversial in the industry, which views it as a costly solution in search of a problem. Credit unions believe this rulemaking is not only unnecessary given how extremely well-capitalized the industry is today, but they also fear this proposal will unjustifiably constrain their ability to grow and serve their communities.

Questions have been raised about the cost of this proposal on industry, the legal authority of the agency to issue the rule that they've proposed, the regulatory burden this new rule would have on credit unions and the impact on credit unions' capital buffers (capital cushions) – which could extend into the hundreds of millions of dollars.

Ultimately, NAFCU believes legislative changes are necessary to bring about comprehensive capital reform for credit unions that would reflect lower capital requirements for lower-risk credit unions and higher capital requirements for higher-risk credit unions. Such a system should move away from the static net-worth ratio to a system where NCUA joins the other banking regulators in having greater flexibility in establishing capital standards for institutions. NAFCU also believes that capital reform must include access to supplemental capital for all credit unions and we would urge your support for H.R. 989, the *Capital Access for Small Businesses and Jobs Act.*

On June 15, 2015, Representatives Fincher, Heck and Posey introduced the bipartisan *Credit Union Risk-Based Capital Study Act of 2015* (H.R. 2769). This legislation would stop NCUA from moving forward with their second risk-based capital proposal until completing and delivering to Congress a thorough study addressing NCUA's legal authority, the proposal's impact on credit union lending, capital requirements for credit unions compared to other financial institutions and more. Additionally, NCUA could make any legislative recommendations that would help with the implementation of a new capital system. The agency would not be able to finalize or implement the proposal before 120 days after the report goes to Congress. This "time-out" would give everybody a chance to examine the issue in greater detail. NAFCU urges you to support this legislation.

Regulatory Relief

Regulatory burden is the top challenge facing all credit unions. While smaller credit unions continue to disappear as a result of the growing burden, all credit unions are finding the current environment challenging. Finding ways to cut-down on burdensome and unnecessary regulatory compliance costs is the only way for credit unions to thrive and continue to provide their member-owners with basic financial services and the exemplary service they need and deserve. It is also a top goal of NAFCU.

We hope NCUA will use this opportunity to outline areas where they support legislative regulatory relief and areas where the agency plans to act to provide relief. A prime example of NCUA action is the agency's Fixed Assets proposal which is scheduled to be finalized tomorrow. The agency should be commended for bringing this long needed relief to credit unions. We hope NCUA Chairman Debbie Matz will outline more areas where the agency plans to take such steps in her testimony tomorrow.

For example, NAFCU believes that the agency could do more under existing law to provide field-of-membership relief for credit unions. Further, NAFCU believes that NCUA can remedy and streamline the process of applying for field of membership expansions or conversions. Many federal credit unions (FCUs) report that they must wait between 18 months to two years before a field of membership expansion request is approved or denied by NCUA. Often, during the extensive waiting time after the application has been submitted, the FCU is rarely provided any information from NCUA about the status of their request.

NAFCU believes NCUA has the existing statutory authority to make the following field of membership changes:

- Require deadlines for FOM amendment requests
- Increase transparency in the agency's decision making process
- Streamline cumbersome notification requirements
- Make it easier for a FCU to convert to a community charter
- Clarify the definition of "rural district"
- Recognize the growth of technology in defining a "community"
- Modifying the service facility requirement to recognize online banking services
- Provide greater flexibility with Trade, Industry, or Profession (TIP) charters

We also recognize the recent proposal by NCUA to improve the member business lending process at credit unions. You may have heard from banking trades that mischaracterize this proposal as an attempt to circumvent the statutory member business lending cap at credit unions, but in reality this is a proposal to cut "regulatory red-tape" for credit unions and our nation's small businesses by removing overly prescriptive restrictions the agency placed on credit union business lending a number of years ago in favor of a more comprehensive and overall principle-based risk management policy for business lending at each credit union. The bankers are simply attempting to unfairly limit competition.

NAFCU also urges you to support legislation that would provide credit unions with relief from the arbitrary member business lending (MBL) cap. Legislation such as H.R. 1188, the *Credit Union Small Business Jobs Creation Act* (which would raise the MBL cap to 27.5% of assets), H.R. 1422, the *Credit Union Residential Loan Parity Act* (which would exempt non-owner occupied 1-4 family dwelling loans from the MBL cap), and H.R. 1133 (which would exempt loans made to veterans from the MBL cap) deserve your support.

We hope areas such as field-of-membership reforms, the agency's proposed changes to the member business lending process and pass-through share insurance coverage will be areas of regulatory relief covered by Chairman Matz tomorrow. We urge you to encourage the agency to be aggressive in its actions to provide relief moving forward.

NCUA and Third-Party Vendor Examination Authority

NAFCU opposes the agency's call for the ability to examine third-party vendors. We view this as regulatory overreach that would prove costly and create new burdens for the industry. When NCUA previously had this authority for Y2K concerns, Congress specifically had the authority sunset and chose not to renew it. The NCUA budget has already increased over 50% during the past five years. The budget would continue to increase dramatically if NCUA had to hire or contract experts in every field that credit unions contract to third parties in order to examine vendors. NCUA already has the tools it needs to address risk through its examination of credit unions directly.

NCUA has cited cybersecurity as a reason it should have vendor examination authority over technology vendors. However, the key to safety and soundness for credit unions is the credit union relationship with the third party, which is already subject to the examination process.

Credit unions are proud of their track record of success in helping consumers and the American economy. We ultimately want fair regulation that ensures safety and soundness but does not hamper our ability to provide the services that our nation's 100 million credit union members desire. We thank you for holding this important hearing. If my staff or I can be of assistance to you, or if you have any questions about credit unions, please feel free to contact myself or NAFCU's Vice President of Legislative Affairs Brad Thaler at (703) 842-2204.

Sincerely,

Carrie R. Hunt

Carrie R. Hunt
Senior Vice President of Government Affairs and General Counsel

cc: Members of the House Financial Services Committee

NASCUS
National Association of State Credit Union Supervisors

July 22, 2015

The Honorable Randy Neugebauer
Chairman
Subcommittee on Financial
Institutions and Consumer Credit
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable William Lacy Clay
Ranking Member
Subcommittee on Financial
Institutions and Consumer Credit
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Neugebauer and Ranking Member Clay:

On behalf of the National Association of State Credit Union Supervisors (NASCUS), the professional association representing our nation's state credit union regulators, I am writing today in respect to tomorrow's hearing on the National Credit Union Administration's Operations and Budget. NASCUS encourages the subcommittee to carefully examine the proper separation within the NCUA of insurance and supervisory functions, and the impact of that imprecise distinction on the health and well-being of the dual chartering system. In particular, NASCUS is concerned that the agency's funding mechanism and examination cycles are having an inequitable impact on state chartered credit unions and state regulators.

A primary and long-standing priority of NASCUS is achieving meaningful transparency around the NCUA's budget and its allocation of expenses across state and federal credit unions. As both a charterer and share insurer, NCUA primarily funds itself in two ways: through direct assessments on federal credit unions, and by transferring money from the share insurance fund that is contributed by both state and federal charters. Currently, the agency funds over 70% of its total budget from share insurance fund monies through the overhead transfer rate (OTR).

Generally speaking, increases in the portion of the budget funded by the OTR have led to decreases in direct assessments on federal credit unions. For example, by increasing the OTR in 2014, NCUA was able to shift a substantial portion of its expenses to the insurance fund, thereby enabling NCUA to *reduce* 2014 federal credit union operating fees by $10.5 million despite an *increase* of $26.5 million in its 2014 operating budget. This represents a significant reallocation of direct assessment expenses for federal credit unions into indirect insurance fund contributions which are borne by both state and federal credit unions.

Given the inherent conflict of interest between NCUA's roles as a competing chartering authority and common insurer it is imperative that stakeholders be given the opportunity to evaluate and formally respond to NCUA's allocation of expenses across the industry. Consequently, NASCUS supports the NCUA Budget Transparency Act (H.R. 2287) which would require NCUA to open its budget process to notice and comment from stakeholders.

Additionally, NASCUS urges the subcommittee to push NCUA to raise the threshold for its annual insurance exam of state-chartered credit unions. NCUA currently examines all federally-insured credit unions with assets in excess of $250 million on a 12 month cycle, regardless of their CAMEL rating, risk profile, or frequency of examination by the state. In some cases, this inflexible policy can lead to state-chartered credit unions with over $250 million in assets being subject to two separate on-site exams in a 12 month period.

NCUA could ease the regulatory burden for credit unions, and enable valuable supervisory discretion for state regulators, by raising the threshold for annual insurance exams to institutions with assets of $500 million or more, and relying on state regulator exams for institutions below that threshold on a risk-based basis.

State agencies conduct regular on-site examinations of their credit unions and, absent a specific insurance-related concern, NCUA should rely on those exams as envisioned by the Federal Credit Union Act. This adjustment would free up supervisory resources, both at the NCUA and state level, to focus on problem institutions and emerging areas of supervisory concern, such as cybersecurity. Although, in theory, the risk profile of a $250 million credit union could change rapidly, NCUA and the states have off-site tools to monitor the condition of credit unions remotely. In conjunction with on-site state exams, this should provide NCUA sufficient information to evaluate the insurance risk of these credit unions. Furthermore, the health of any individual $250 million credit union does not pose a systemic risk to the share insurance fund.

We appreciate the opportunity to share our concerns with the subcommittee, and we hope that you take this opportunity to stress the importance of the dual chartering system, the value of transparent and meaningful stakeholder input, and the critical distinction between supervisory and insurance functions to the NCUA Chairman.

If NASCUS can be of any assistance on this or any issue, please don't hesitate to reach out to me directly, or to our Regulatory and Public Policy Counsel, Sabrina Bergen, at (703) 528-0669.

Sincerely,

Lucy Ito
President & CEO

cc: Members of the Subcommittee on Financial Institutions and Consumer Credit, House Financial Services Committee

House Subcommittee on Financial Institutions and Consumer Credit
Hearing on National Credit Union Administration Operations and Budget
July 23, 2015

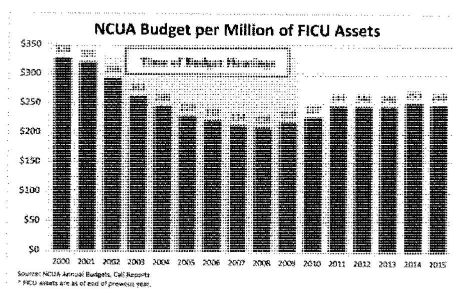
Questions for Debbie Matz, Board Chairman, National Credit Union Administration, from Subcommittee Chairman Randy Neugebauer

1. ***According to the NCUA Inspector General's material loss reviews, NCUA examiners routinely identified problems on a timely basis. There is no indication that any of the credit unions that ultimately failed were not regularly examined. The reports do reveal flaws in the agency's follow-through with judicious supervision and well-tailored enforcement, which contributed to the failures.***

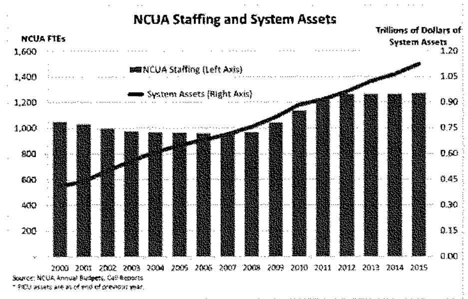
   Will you provide Committee with a list of credit unions that failed during the crisis as a direct result of inadequate NCUA staffing or supervision? How will an increase in staffing prevent the failure of supervision and enforcement? Should NCUA's failure be rewarded with more funding?

Before examining the number of credit unions that failed during the financial crisis, it's important to look at the changes in the NCUA budget during the years leading up to the crisis. As noted in my testimony, the NCUA Board held annual budget hearings between 2001 and 2008 affecting the 2002 through 2009 budgets.

During the years of these hearings, NCUA's budgets failed to keep an appropriate pace with growing credit union assets, risks, product and service complexity, and industry interconnectedness and concentration. In fact, as shown in the chart below, NCUA's budget per million dollars of federally insured credit union assets dropped from $321 per million dollars of system assets in 2001, the year before budget hearings began, to $219 per million in 2009, the last year affected by the budget hearings. The difference over this timeframe represents a drop of more than 30 percent in available resources.



As illustrated in the chart at the top of the next page, during the same seven years leading up to the financial crisis, NCUA also cut a total of 91 staff positions—even though credit union assets had increased by 73 percent.



To facilitate these budget and personnel cuts, NCUA adopted a delayed examination cycle extending periods between examinations for institutions not identified as troubled for up to 24 months, with an average of 18 months. The program ultimately reduced the number of full examinations completed.

While NCUA met planned program needs, the staffing levels during this time did not provide the additional staffing needed to materially expand supervision activities for all identified emerging risks. As a result, an emerging risk that was once addressed with an interim follow-up supervision contact could only occur where NCUA staff identified the threat to the National Credit Union Share Insurance Fund as imminent.

Historically, well-run credit unions with an identified emerging risk—such as a growing concentration of real estate loans—received an informal enforcement with the expectation that management would address those concerns in the normal course of business, as had happened in the past. Examiners did not have sufficient time to perform additional onsite visitations, where the perceived risk was manageable. Thus, the extended examination cycle allowed an emerging threat to grow more significant if left unresolved by credit union management.

In the capping report that you cite about material loss reviews, NCUA's Inspector General criticized NCUA for not more aggressively pursuing problem areas through supervision and enforcement potentially reducing losses. The critical pre-crisis staff reduction hurt the ability of NCUA to respond initially to the financial crisis. As a result, substantial staff increases were necessary for NCUA to rebuild the examination and supervision program necessary to ensure the safety and soundness of credit unions going forward. I addressed those issues as soon as I became NCUA Board Chairman.

Long before the Inspector General issued the report criticizing NCUA's lack of appropriate supervision and enforcement, I recognized the need to address this issue. Soon after I became NCUA Board Chairman, we quickly established an expectation that repeat serious Documents of Resolution would not be tolerated. We also instructed examiners to move to stricter enforcement actions and, where necessary, formal enforcements to resolve identified problems.

We continued to study causes of losses, and further refined our policy on Documents of Resolution in 2013. We fully trained staff and established the clear message to credit unions that a Document of Resolution is serious, and it must be resolved by credit union management promptly to avoid rapid and aggressive enforcement.

From 2008 through 2011, 90 federally insured consumer credit unions failed, which means they were subject to an involuntary liquidation or an assisted merger. This number reflects a failure rate of 1.1 percent (90 failures out of 8,101 federal insured credit unions as of December 31, 2007). In comparison, 414 federally insured banks and thrifts failed during the same timeframe, for a failure rate of 4.9 percent (414 failures out of 8,533 institutions insured by the Federal Deposit Insurance Corporation as of December 31, 2007). In addition to the failure of 90 consumer credit unions listed on the next page, five corporate credit unions failed during the Great Recession: U.S. Central, WesCorp, Members United, Southwest, and Constitution.

It is important to note that NCUA also partners with state supervisors. While NCUA will take any action authorized under the Federal Credit Union Act—to protect the interest of consumers, the integrity of the credit union system, and the solvency of the Share Insurance Fund—we also have a responsibility to balance our risk-management needs with the resources and sovereignty of the state authority as the prudential regulator for 38 percent of our federally insured institutions, to the extent practicable. As a result, we have historically relied on state examinations for a large number of state-regulated credit unions.

Of the 90 failures occurring between 2008 and 2011, 63 were federal credit unions and 27 were federally insured, state-chartered credit unions. While state-chartered credit unions were slightly less likely to fail—that is 30 percent of the failures versus 38 percent of the insured units—the Share Insurance Fund losses at these institutions were higher. On average, the Share Insurance Fund lost $5.8 million at each failed federal charter and $12.2 million at each failed state charter.

The changes that have occurred during my time as Board Chairman have provided tangible and intangible benefits to the credit union system. NCUA has returned to an annual examination cycle for credit unions. This has allowed NCUA to more rapidly uncover losses, including fraud, and emerging risks not promptly addressed by credit union management. It has also allowed NCUA to add specialized examiners with the expertise needed to appropriately identify and address emerging risk resulting from an increasing number of complex and large credit unions.

Additionally, in response to the Inspector General's report on failures and our experience with risk exposure and losses to the Share Insurance Fund, NCUA lowered the dollar threshold of state-chartered credit unions that must receive a full examination every calendar year to $250 million. This change further enhanced our ability to more effectively identify and aggressively pursue resolution where problems exist. Finally, NCUA, under my leadership, has undertaken a modernization of our existing regulatory structure to properly scale regulation with the level of risk posed to Share Insurance Fund while minimizing or reducing administrative and regulatory burden to thousands of low-risk credit unions.

Federally Insured Credit Union Failures from All Causes 2008 to 2011

Federally Regulated Failures

Average Asset Size	27,366,996
Total Losses	362,502,731
Average Loss/CU	5,754,012

Date	Name	State	Assets @ fail
03/05/2008	St. Luke Baptist	NY	49,734
12/05/2008	Father Burke	NY	1,402,075
05/30/2008	Peoples FIrst Choice	PA	20,262,282
07/15/2008	Meridian F A	CT	759,017
07/28/2008	New London Security	CT	12,741,066
04/08/2008	1st United	CA	17,827,347
05/08/2008	Port Trust	SC	507,670
09/16/2008	Interfaith	NJ	387,995
09/26/2008	Kaiperm	CA	95,105,604
03/10/2008	N & W Poca Division	WV	2,829,775
10/10/2008	BBM	AL	689,077
12/31/2008	Clara Barton	DC	9,340,136

Date	Name	State	Assets @ fail
01/01/2009	Channel Island	CA	19,232,278
01/01/2009	Bishop de Mazenod	TX	55,836
02/13/2009	Center Valley	WV	8,379,924
03/31/2009	Fort Snelling	MN	33,663,989
06/05/2009	First American	TX	21,605,090
10/06/2009	Norwood School Employees	MA	301,454
06/30/2009	High Desert	CA	94,406,106
07/22/2009	Kabel	OH	102,540
11/08/2009	Community One	NV	159,181,112
08/27/2009	Free Choice	PA	325,807
09/22/2009	Comunidades	CA	704,413
09/30/2009	The Members' Own	CA	85,258,530
11/13/2009	Ensign	NV	98,271,424
11/30/2009	Fairfield County Ohio	OH	1,468,684
12/31/2009	Allied Tube Employees	IL	1,019,664
12/31/2009	Heritage West	UT	307,732,440
12/31/2009	GCM	WI	5,669,222

Date	Name	State	Assets @ fail
01/21/2010	Phillips County Self Help	AR	287,520
02/02/2010	Bestwall Brunswick	GA	172,522
05/02/2010	Coastal Waters	AL	4,793,319
02/25/2010	Friendship Community	MS	860,142
02/25/2010	Community Choice	IN	2,421,241
02/28/2010	Mututal Diversified	CA	6,077,603
05/03/2010	Lawrence County School Emp	PA	2,551,912
04/27/2010	Tracy	CA	24,860,744
04/30/2010	St Paul Croatian	OH	250,853,608
04/30/2010	Bethel GT	NY	305,575
01/05/2010	Liberty Alliance	KY	38,204,713
01/05/2010	A.L. Bratcher	AL	787,302
05/17/2010	Convent	NY	215,097
06/30/2010	SouthWest Community	UT	135,602,764
06/30/2010	First Delta	MS	71,869
07/31/2010	Certified	CA	37,688,813
03/08/2010	Kappa Alpha Psi	TX	750,113
08/31/2010	Table Rock	MO	1,038,344
01/09/2010	East Central	MS	2,899,244
09/13/2010	Industries Puerto Rico	PR	3,655,725
10/18/2010	Phil-Pet	TX	3,700,764

Date	Name	State	Assets @ fail
02/15/2011	Family First	UT	119,371,315
02/23/2011	NYC OTB	NY	1,827,980
07/03/2011	Land of Enchantment	NM	8,592,639
08/04/2011	Mission San Francisco	CA	5,938,186
01/05/2011	South Dekalb Church	GA	3,167,906
05/18/2011	Hmong American	MN	2,738,737
05/31/2011	Valued Members	MS	9,059,678
06/24/2011	St. James AME	NJ	1,045,995
08/07/2011	Borinquen	PA	5,218,048
11/07/2011	Vensure	AZ	7,297,056
11/30/2011	BCT	NY	38,141,333
02/12/2011	O.U.R.	OR	3,296,436
12/16/2011	Birmingham Financial	AL	1,346,191

State Regulated Failures

Average Asset Size	134,136,314
Total Losses	328,884,002
Average Loss/CU	12,180,889

Date	Name	State	Assets @ fail
02/29/2008	Norlarco	CO	287,221,174
06/30/2008	Cal State 9	CA	285,372,898
06/30/2008	Sterlent	CA	88,861,607
01/07/2008	Electrical Workers	IL	3,322,769
09/26/2008	TEXDOT-WF	TX	1,890,533
05/12/2008	West Hartford	CT	2,865,180
12/31/2008	Valley	CA	216,026,357

Date	Name	State	Assets @ fail
08/01/2010	Kern Central	CA	34,336,906
08/04/2010	South End Mutual	CT	1,420,516
09/06/2010	Orange County Employees	TX	1,712,459
07/29/2010	Norbel	CO	115,410,940
08/31/2010	First American	WI	136,892,301
10/29/2010	The Union	WA	11,837,805
12/14/2010	Beehive	UT	145,451,557

Date	Name	State	Assets @ fail
05/15/2009	Rouge Employees	MI	22,905,789
06/30/2009	Watts United	CA	874,703
06/30/2009	Eastern Financial	FL	1,623,575,224
08/24/2009	Service Plus	CA	84,073,302
08/31/2009	First Security	WI	30,375,184
08/31/2009	Kaiser Lakeside	CA	24,028,192
09/25/2009	Clearstar Financial	NV	150,136,747
09/30/2009	West Texas	TX	72,442,646
10/30/2009	Second Baptist	CA	399,339
12/31/2009	First Service	WI	33,973,894

Date	Name	State	Assets @ fail
04/02/2011	Oakland Municipal	CA	88,172,807
04/03/2011	Wisconsin Heights	WI	713,505
04/29/2011	Utah Central	UT	157,386,149

The distribution between state and federal credit union failures is approximately equal to the distribution of the entire population of federally insured credit unions. Federal credit unions represented approximately 62% of all active credit unions in 2007 and continue to represent approximately 62% of the active credit unions in 2015.

2. ***Chairman Matz, prior to your tenure, the NCUA regularly held annual public budget hearings. What is the legal basis for your decision to discontinue NCUA budget hearings, which provide greater transparency and accountability on the agency's budget?***

   Instead of public budget hearings, is it reasonable to instead hold conversations with stakeholders out of the public eye, in your office, and at lunches and dinners? Are you suggesting the Board is weak-willed? Are you suggesting the Board can be compromised? Do you have concerns about having to justify budget priorities and the NCUA's spending?

Independence is the hallmark of federal financial institutions regulators. In my view, Congress wisely designated NCUA as an independent agency, along with other federal banking agencies, such as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. This independence insulates regulators of financial institutions from inappropriate political pressures on policy or budget matters from the entities the agencies regulate. Requiring NCUA to subject its pre-decisional budget to the hearing-and-comment process would erode one of the basic policy foundations of the agency's independence and result in additional industry pressure being placed on the NCUA Board to reduce the agency's examination budgets.

Policymakers concerned about ensuring safety and soundness should consider the lessons of the past when trade groups had access to pre-decisional budget information. Rather than repeat history, NCUA needs to have the capability to detect and resolve problems before those problems cause credit union failures.

The policy decision to discontinue NCUA's budget hearings and the agency's concern about legislation to mandate budget hearings arise from this experience. As noted in the answer to the first question, when NCUA held public budget briefings from 2001 to 2008 during the run-up to the financial crisis, credit union trade groups consistently advocated for cuts to NCUA's budget and exam hours. Subsequent to these hearings, the NCUA Board approved budgets that failed to keep pace with growing credit union assets, risks, product and service complexity, concentration, and industry interconnectedness. For example, during the seven years leading up to the financial crisis, NCUA cut a total of 91 staff positions—even though credit union assets had increased by 73 percent. As a result, NCUA was under-staffed and under-resourced when the crisis hit.

This critical pre-crisis staff reduction hurt the ability of NCUA to respond initially to the financial crisis. The NCUA Board voted unanimously to phase in the needed staffing over time. It took three years of budget increases for NCUA to regain the ground it had lost before the crisis and become as effective as it could and should have been.

NCUA implemented these budgets using zero-based budgeting techniques to ensure each planned expense is individually justified and consistent with the agency's overall strategic plan.

Despite these concerns about budget hearings, I recognize that transparency is also a hallmark of good government. Compared to other federal banking agencies, NCUA is the most transparent in terms of the information we release about our budget and the budget process.

In the interests of transparency and accountability, NCUA has made over 80 documents related to our budgets and budget processes available on our website to the public.[1] This information includes: Board action memorandums on the budget, budget briefing summaries, answers to budget questions submitted by trade groups and credit unions, detailed information about budget breakdowns by NCUA offices, and summary fact sheets on issues such as the budget process and prioritizing information technology expenditures. NCUA also posts the annual audits of all funds under management on its website.

The posted financial information provides a high level of disclosure and transparency of our budget and budget-making process. With this information, concerned stakeholders have ample opportunity to examine our budget and convey their views in writing about NCUA's current and future budgets. Indeed, each year the Board already receives letters prior to our budget vote from each trade group urging us to reduce examinations and flatten the budget.

Presently, there are several statutory requirements related to transparency and accountability with which NCUA complies. Under the Federal Credit Union Act, NCUA reports annually to the President and Congress. This report summarizes the operations of the agency and sets forth such information as is necessary for the Congress to review the financial program approved by the Board. Further, NCUA's financial transactions are subject to audit by the Government Accountability Office.

NCUA must also report annually to the Senate Banking Committee and House Financial Services Committee about the operations of the National Credit Union Share Insurance Fund, which insures deposits at federally insured credit unions. This report must include the results of an independent audit of the Share Insurance Fund.

Finally, NCUA annually must prepare and submit a "business-type budget as provided for wholly owned Government corporations." NCUA must also "maintain an integral set of accounts, which shall be audited by the Government Accountability Office in accordance with principles and procedures applicable to commercial corporate transactions."

Recognizing the value in the open and free exchange of ideas, I also regularly seek insights and input from stakeholders in a variety of public settings. From one-on-one meetings to town-hall settings, conferences, telephone conversations, and coordinated field meetings, I am accessible to discuss the budget and other matters. I routinely crisscross the country speaking to and meeting with tens of thousands of credit union officials representing every state.

To further emphasize my commitment to enhanced transparency and effective communications, I have held 18 in-person Listening Sessions and 12 online town-hall style webinars since rejoining the NCUA Board. Again, these Listening Sessions and webinars are open to all interested parties.

3. ***Page 18 of the NCUA's 2014 Annual Report states that of the 15 credit unions that failed in 2014, "Fraud was a contributing factor in seven of these failures in 2014, costing the Share Insurance Fund $36.5 million."***

[1] See http://www.ncua.gov/about/Pages/budget.aspx.

If the NCUA is focused on preventing losses to the NCUSIF, it stands to reason that NCUA should devote its resources to fraud prevention, not on unnecessary new rules. Why do you not insist that NCUA focus on fraud prevention and focus resources where they will surely do the most good?

The primary purpose of NCUA's examination and supervision program is to ensure federally insured credit unions comply with applicable laws and regulations and operate in a safe and sound manner. Safety and soundness expectations for insured credit unions include internal controls to deter and detect fraud. As such, NCUA conducts a review of internal controls on a risk-focused basis and has incorporated fraud detection techniques into some aspects of the examination program.

As I noted in my answer to a question from Congressman Tipton during the hearing, I am concerned about fraud, but the impact of fraud-related failures on the National Credit Union Share Insurance Fund is typically not material. Because employee fraud is mainly a small credit union problem, the aggregate risk to the Share Insurance Fund from small institutions is limited. Credit unions with less than $50 million in assets hold only 5 percent of total system assets in aggregate. And, even though roughly 40 to 50 percent of losses over the last decade to the Share Insurance Fund have fraud as a contributor, the average annual loss has not been material in the context of the health of the Share Insurance Fund, except for one extraordinary loss in 2010.

While they are regulated entities, credit unions are also private organizations. Therefore, fraud prevention must first start at the credit union. Credit unions must establish effective internal controls to prevent fraud and detect instances of fraud early when the losses are still manageable. Effective internal controls include the adoption of a board-approved fraud policy signed by employees on an annual basis, surprise cash counts, separation of duties, procedures related to employee family accounts, processes for counting vault cash, and procedures for completing file maintenance transactions.

Small credit unions are inherently susceptible to fraud as it is difficult to provide for segregation of duties due to limited resources, few staff, and a lack of external financial audits. Fraud is also inherently difficult to detect during examinations because the individuals perpetrating the fraud are typically working actively to conceal it. One must have proof of the fraud, not just symptoms or suspicions. Moreover, many mismanagement problems look like fraud, and many frauds look like mismanagement. NCUA could very quickly spend an inordinate amount of money and resources on a programmatic basis searching for fraud that would exceed the costs of the actual fraud occurring, not to mention burdening innocent institutions with a more extensive exam. We must, therefore, find an appropriate balance, one that works to identify fraud and minimizes burdens on small credit unions.

To help credit unions prevent fraud, NCUA has implemented a variety of measures to provide training and resources for credit unions. For example, NCUA's Office of Small Credit Union Initiatives released online training videos in 2014 about *Deterring, Preventing & Detecting Employee Dishonesty*. These eight videos, together, have had more than 20,000 views. The Office of Small Credit Union Initiatives has also conducted webinars on internal controls and fraud prevention in recent years.

To promote the early detection of apparent fraud and insider abuse, NCUA has provided guidance to examiners on internal controls and other fraud-prevention and detection techniques through various training platforms. NCUA has expanded fraud training for both new and seasoned examiner staff. The new examiner training program was retooled with a fraud focus, including additional transaction testing procedures. Content in various training classes also was updated to include training on the reconciliation of bank statements and fraud indicators.

Additionally, NCUA has repurposed existing agency positions to provide more expertise and coordination for the agency's anti-fraud program. The Office of Examination and Insurance established a fraud and risk analysis specialist position and hired an individual with extensive law enforcement experience. This specialist is coordinating the development of additional fraud resources and tools, liaising with law enforcement and other government agencies, establishing additional fraud training, and assisting with actual fraud cases.

In addition to returning to an annual exam cycle, NCUA has implemented a variety of improvements to the agency's exam program to detect any material fraud in a credit union earlier. In 2011, for example, NCUA began developing a Small Credit Union Exam Program that incorporates fraud-detection techniques. The new program was launched in the first quarter of 2015 after extensive testing in 2013 and 2014. The program contains defined-scope exam procedures that include transaction testing that would be more likely to detect material fraud in a credit union, if it exists.

The agency's examination software system was also updated to include additional examination procedures designed to aid in detecting and documenting fraud in credit unions of all sizes. Further, NCUA has recently incorporated an expanded series of "red flags" reports into our surveillance systems that are designed to identify potential fraud.

Finally, it is important to put the agency's anti-fraud efforts into a larger context. NCUA is using a multi-pronged, but measured, approach to combat fraud given resource considerations and inherent challenges in detecting fraud. NCUA's risk mainly relates to material employee fraud in a credit union, not small-dollar thefts committed by a teller for example. The Share Insurance Fund is in the third-loss position on fraud, behind the credit union's capital and the fidelity bond coverage required under the agency's rules.[2] Therefore, unlike other forms of risk or mismanagement where NCUA is in the second-loss position, there is a built-in additional layer of protection for the Share Insurance Fund when it comes to fraud.

4. ***During the hearing the following exchange occurred:***

WILLIAMS: Would you provide this committee will a complete list of employees who have received these bonuses in 2014 and 2015 so that we can shed some light on the policy and learn more how it works?
MATZ: Sure.
WILLIAMS: Would you do that for us?
MATZ: Absolutely.

[2] See 12 C.F.R. 713.

Please provide the committee with a complete list of employees who have received these bonuses in 2014 and 2015, including the amounts received, the manager authorizing each award, and the dates received. Please provide all relevant policies and other records governing this practice.

All of the requested information was provided to Congressman Williams' office in August 2015, with copies provided to both you and Ranking Member Clay. For the record, I am including a brief summary of the detailed information NCUA provided to the three congressional offices. The information submitted included the name of each award recipient, office, date of each award, amount of each award, and name of each awarding supervisor for 2014 and 2015.

Federal award guidance issued by the U.S. Office of Personnel Management and the U.S. Office of Management and Budget calls for limiting award spending to no more than 5 percent of total salaries for executives and no more than 1 percent of total salaries for non-executives. In calendar year 2014, NCUA spent 0.60 percent of total executive salaries on awards and 0.61 percent of total non-executive salaries on awards. Thus, NCUA is in compliance with federal award guidance and well under the limits prescribed by these agencies. Also, part of the agency's submission to the three congressional offices included a chart with the salary and award totals and percentages by executives and non-executives.

Please note that year 2015 awards were itemized from January 1, 2015, through July 23, 2015, the date of Congressman Williams' request. The average award during this period was $489.

As requested, we also included all relevant policies and records governing NCUA's incentive awards, including:

- The joint-agency guidance about awards from the U.S. Office of Personnel Management and the U.S. Office of Management and Budget issued in November 2013. The guidance remains in effect.
- A copy of our current incentive awards chapter from the *NCUA Personnel Manual* adopted in March 2012. The chapter remains in effect.
- The delegations of authority related to incentive awards through September 2014. These delegations also remain in effect.

NCUA staff is available to provide additional information or answer other questions about NCUA's awards program.

5. ***The 2015 budget for the Office of the General Counsel is $6.7 million, a 7 percent increase, despite no increase in the number of employees. What is driving this cost increase? Pay and benefits are up 8 percent, which exceeds the average for the rest of the agency. Why has pay gone up so much this year?***

The Office of General Counsel's budget decreased for every other cost category other than pay and benefits, which are annually adjusted for all staff in each office.

The pay and benefits budget for the Office of General Counsel increased mostly due to the merit and locality pay adjustments, which account for approximately $400,000. NCUA had frozen or limited locality pay adjustments for several years, despite increases in local costs of living. While the agency began making catch-up locality payments in 2015, NCUA locality pay generally lags behind other federal financial institutions regulators.

Other, smaller increases to the Office of General Counsel's budget included a $30,000 increase attributed to a part-time employee converting to full-time status. Additionally, four employees were budgeted for career-ladder promotions in 2015, for a total pay and benefits estimated cost increase of approximately $50,000.

6. ***In the 2015 budget for the Office of Consumer Protection, pay and benefits for 2015 are $7.3 million, up 9 percent ($600,000), yet the office is only adding two people. What accounts for this large budget increase? Now that the CFPB has been around for 4 years, how is this office not duplicative and superfluous?***

The Office of Consumer Protection's total pay and benefits change from 2014 to 2015 was $595,970. Of this amount, approximately $187,000, or about one-third of the increase, was associated with two new employees. The other two-thirds or $408,000 was due to the merit and locality increases.

The NCUA Board first approved funds in 2009 to support the Office of Consumer Protection's initial operations in 2010. The office enforces federal financial consumer protection and fair lending laws and regulations, provides regulatory and compliance resources, responds to consumer inquiries and complaints, promotes financial literacy, addresses share insurance matters, and handles chartering and field-of-membership applications, which are unique to federal credit unions.

With respect to any potential overlap with the Consumer Financial Protection Bureau, CFPB's enforcement authority is currently limited to only five credit unions. In contrast, NCUA's Office of Consumer Protection has unique enforcement authority over more than 3,800 federally chartered credit unions with $10 billion or less in assets. NCUA's office performs many essential federal financial consumer protection functions that CFPB does not undertake.

7. ***In the 2015 budget for the Office of National Examinations and Supervision, "Contracted Services" will be increasing from $315,000 to $677,000, an increase of over 115 percent. What is this money being spent on?***

The increase to the contracted services within the Office of National Examinations and Supervision strengthens its oversight of the nation's largest credit unions. The increase primarily supported three initiatives:

- In 2014, the NCUA Board adopted a rule subjecting credit unions with assets of at least $10 billion to annual supervisory stress tests. NCUA presently contracts with a third party to perform the necessary analytics associated with the stress tests. NCUA budgeted $100,000 for 2015 to obtain an independent assessment of costs that would be associated with conducting the stress test analytics independent of the third party.

- NCUA budgeted $150,000 for the procurement in 2015 of a loan analytics platform to stratify large loan portfolios by product mix, risk characteristics, and loan features.
- NCUA budgeted $50,000 to perform cybersecurity penetration testing in 2015 at large, complex credit unions.

8. ***In the 2015 budget for the Chief Financial Officer, the number of employees will remain flat at 39, yet pay and benefits are set to decline by 25 percent. Why is this so?***

When staff vacancies occur during the year, salaries and benefits that are budgeted are not spent. To account for such vacancies, the Chief Financial Officer subtracts from the budget an employee turnover estimate. This subtraction reflects anticipated personnel vacancies based on current and projected hiring trends. These savings are not attributed to individual offices at the start of the budget year because it is not known where vacancies will occur. So, aggregate savings are accounted for through the budget for the Office of the Chief Financial Officer.

The 2015 budget excluded a higher amount from the pay and benefits budget than 2014 to ensure unneeded funds were not collected from credit unions. This change caused the pay and benefits budget to be lower when compared to the prior year's budget for the Office of the Chief Financial Officer.

When the Office of the Chief Financial Officer's budget is viewed separately, without the agency-wide vacancy adjustment, the amount budgeted for the office's staff in 2015 was $6.2 million, compared to $5.8 million for 2014.

9. ***The 2015 budget for the Office of Small Credit Union Initiatives says that half of all small credit unions shrank in 2014, with an average return on assets of just 4 basis points. These institutions are struggling. Yet this budget cuts the programming budget to offset a 5 percent pay increase for office staff. The overall budget is unchanged, so this appears to be a pure shift from programming to employee pay. Can you explain these changes? Is this really the right message to send while small credit unions are dying on the vine?***

The cuts in the programming budget represent an increase in efficiencies, rather than a reduction in programming by the Office of Small Credit Union Initiatives. The office has actually expanded programming outreach to a significantly greater percentage of credit unions.

Over the last five years, even though the number of small credit unions has decreased, the credit union client base for the Office of Small Credit Union Initiatives has grown. This growth has resulted from an increase in the number of low-income designated credit unions, minority depository institutions becoming eligible for the office's services, as well as the change in the definition of small credit union from $10 million to $50 million in assets. In September, the NCUA Board subsequently raised the threshold for defining a small credit union to $100 million in assets. Together, these changes make 85 percent of all credit unions eligible for the office's services.

To provide effective services to a growing credit union client base, the Office of Small Credit Union Initiatives needed to measure its delivery channels and its resulting impact on credit unions. Therefore, the office contracted services for an impact study in 2014. Based on the results of the study, the office has implemented changes in programming to gain greater outreach and better serve credit unions seeking assistance. It automated grant processing, moved from onsite events to online webinars and videos, and developed multiple credit union guides and resources that address small credit union challenges.

These strategic changes have been received positively by credit unions. The Office of Small Credit Union Initiatives' outreach for 2014 included 15,965 webinar participants, 389 credit unions receiving consulting assistance, 331 low-income designated credit unions receiving grant funds, and 12 credit unions receiving loans from the Community Development Revolving Loan Fund program.

Comparing the 2014 budget to the 2015 budget for the Office of Small Credit Union Initiatives, please note:

- For 2015, the office added one new employee to assist in providing services to an expanding credit union base. This $199,000 budgeted for this position includes travel and expenses; and

- The programming decreases reflect the removal of the costs related to the one-time contract for the 2014 impact study.

10. In the 2015 budget for the Office of Human Resources, why does NCUA need 44 HR staff to service fewer than 1,300 employees? NCUA's HR-to-staff ratio is 1-to-30, which is three times higher than the average for a large company. How can you justify the need for a top-heavy HR department? The HR office is spending $3 million on contracted services, to do what? With so many HR personnel, why is there still a need to contract work outside the agency? What exactly are these contractors accomplishing? Please provide copies of all contracts awarded by NCUA to outside vendors for HR-related work.

Human resources comparisons to private-sector companies are not reliable indicators for government agencies, because public and private-sector organizations operate under different laws, rules, and regulations. A more appropriate assessment of NCUA's Office of Human Resources would be to compare its size to similar offices at other federal financial institutions regulators. For those financial regulatory agencies that include training as part of their human resources offices, NCUA's HR-to-staff ratio of one human resources employee to 30 agency employees is in the middle of the range of other agencies of 1:25 and 1:36.

Comparing the staffing of NCUA's Office of Human Resources without the training function, which is how Federal Deposit Insurance Corporation is structured, provides similar results. NCUA has a ratio of one human resources employee to 44 agency employees. On this basis, the other financial institutions regulators range between ratios of 1:28 and 1:48.

Please note that the training provided by NCUA's Office of Human Resources not only includes all of the government employee training required by law, but also the multi-level training of the agency's entire examination workforce. Additionally, NCUA's training staff provide instruction for not only the agency's examiners, but also state credit union examiners. This shared training creates efficiencies within the credit union system. In 2015, the Office of Human Resources will coordinate, develop, and deliver training for 810 federal examiners, 684 state examiners, and 424 management, supervisory, and non-supervisory support staff.

The $3 million for contracted services includes interagency agreements and other contracts for specialized services. Services of this type are routinely provided through interagency agreements with shared service providers, and many are required by law. This is the most cost efficient way to obtain these services.

For 2015, NCUA budgeted $833,338 for these specialized services, which include:

Interagency Agreements

- General Services Administration Comprehensive Human Resources Integrated System Operations and Maintenance Support Fees – $220,000 (required by law)
- Office of Personnel Management Industrial Organization Psychologist support in the development of non-proctored automated writing assessment capability for entry-level credit union examiner evaluation and selection processes – $80,000
- Department of the Interior drug testing services – $3,300 (required by law)
- Department of Health and Human Services Federal Occupational Health Employee Assistance Program – $37,890 (required by law)
- Office of Personnel Management Flexible Spending Accounts fees – $100,000 (required by law)

Other Contracts

- NCUA Savings Plan administration – $254,000
- Contract to support human resources information systems transition to a new Shared Service Provider – $75,000
- Grievance and mediation meetings and associated outside costs – $25,000
- Collective Bargaining Agreement editing and indexing – $15,000
- Arbitration hearing costs $22,500 (required shared cost with union if arbitration is invoked)

The contracted services line also includes $117,500 to fund non-examiner training costs.

The remainder of the contracted services budget line consists of $2,049,500 for examiner training and development. Of this amount, the budget provides $1.8 million for training class delivery, $219,200 for leadership and management development programs, and $12,000 for training event security. The trainers consist of outside vendors and agency employees.

The Office of Human Resources is working to gather the requested contracts and interagency agreements, and these documents will be provided to you as soon as possible.

11. ***The NCUA commissioned an opinion from a law firm Paul Hastings to write you a legal opinion justifying your Risk-Based Net Worth proposal. The NCUA website says your Office of the General Counsel "has responsibility for all legal matters affecting NCUA, including...providing interpretations of the Federal Credit Union Act and NCUA rules and regulations to the agency and to outside parties." Further, your general counsel, Michael McKenna is the agency's top-paid staffer, making $250,000 in 2013, according to a news article.***

    a. ***In light of these facts, why was it necessary to secure outside counsel to produce this opinion? Is your general counsel up to the task? Did he also provide you with an internal legal opinion? Please provide all NCUA records evaluating the agency's legal authority to issue its Risk-Based Net Worth proposal.***

Debates about the legality of the risk-based capital proposed rule have centered on NCUA's authority to require credit unions to maintain different risk-based net worth ratio levels to be classified as adequately capitalized or well capitalized. As published in the *Federal Register*, NCUA's Office of General Counsel drafted the legal authority section in the preamble of the revised proposed rule to outline NCUA's authority to require a two-tiered risk-based capital system.[3]

Because the questions about NCUA's legal authority to impose a two-tiered risk-based capital regime posed by commenters on the first proposal raised fundamental questions about the design of NCUA's risk-based capital framework, I concluded that before proceeding further the agency should obtain an independent legal opinion from an outside law firm. This decision did not result from a lack of confidence in the General Counsel's opinion on the issue. Indeed, at the January open Board meeting at which the revised proposal was adopted, I noted my complete confidence in the legal advice provided by NCUA's Office of General Counsel. Rather, after reviewing the legal concerns raised by some during the first comment period, I felt it prudent to conduct my own, independent due diligence on this very important issue.

In preparing the scope of work, it was made clear that the law firm was to provide an unbiased legal opinion on the issue, and that NCUA would not influence or pre-determine the legal opinion. If the opinion found that NCUA lacked the legal authority to propose different risk-based thresholds to be well capitalized and adequately capitalized, then NCUA would have redrafted the proposed rule accordingly. The opinion from Paul Hastings concluded that NCUA does have the authority to adopt a two-tiered risk-based threshold as part of a modernized risk-based capital system. Thus, NCUA's General Counsel and an independent law firm have each separately concluded that NCUA has the authority to adopt a two-tiered risk-based capital system.

NCUA's Office of General Counsel prepared an internal legal memorandum on the issue, which is protected by attorney-client privilege and, therefore, not included in this response. Our attorneys are available to meet with your staff in person to discuss the memorandum. The Paul Hastings legal opinion is available on NCUA's website and attached for your review.[4]

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[3] See 80 FR 4340 (January 27, 2015).

[4] See http://www.ncua.gov/News/Documents/NW20150120Opinion.pdf.

b. ***What was the cost of procuring this Paul Hastings opinion? We have heard that the opinion cost the agency $50,000, and a briefing for staff cost the agency an additional $100,000 for a total cost of $150,000. Is this accurate? Why was the briefing necessary? Please provide a list of all NCUA staff who were briefed by Paul Hastings. Was this cost paid out of the Share Insurance Fund?***

The cost of Paul Hastings' legal work included $100,000 for the oral opinion and multiple consultations with all Board members, plus $50,000 for a written opinion. I should note that this was not a new budget request; it was paid in 2014 from our Office of General Counsel's line item for contracted legal services contained in the agency's annual budget.

The firm researched every legal issue in the proposed rule for several months, during which outside counsel reviewed all of the 2,056 official comment letters, plus any additional letters we received that questioned NCUA's legal authority. In October, a team from Paul Hastings presented an oral legal opinion to the NCUA Board, senior staff, and staff involved in the rulemaking. According to records, the following agency personnel attended the meeting:

- Board Chairman Debbie Matz
- Board Vice Chairman Rick Metsger
- Board Member J. Mark McWatters (by phone)
- Steve Bosack (Office of the Board)
- Mike Radway (Office of the Board)
- Sarah Vega (Office of the Board)
- James (Buddy) Gill (Office of the Board)
- Mark Treichel (Executive Director)
- Michael McKenna (General Counsel)
- Lara Rodriguez (Office of General Counsel)
- Frank Kressman (Office of General Counsel)
- Justin Anderson (Office of General Counsel)
- John Brolin (Office of General Counsel)
- Todd M. Harper (Office of Public and Congressional Affairs)
- Larry Fazio (Office of Examination and Insurance)
- JeanMarie Komyathy (Office of Examination and Insurance)
- Steve Farrar (Office of Examination and Insurance)

During the oral briefing and in the weeks that followed, each Board member, at his or her own discretion, had access to Paul Hastings' lead attorney for further discussions of the issue.

c. ***How many other law firms did you solicit before selecting Paul Hastings?***

During the summer of 2014, bids were solicited from 11 law firms around the country that specialize in financial services statutes and regulations. The Global Banking and Payment Systems practice of Paul Hastings—based in Washington, D.C.—was ultimately selected. Paul Hastings has a stellar reputation on legal issues related to prompt corrective action, from the perspectives of financial institutions as well as from the perspective of a federal agency.

d. ***Pages 12-13 of your annual report state that a "final rule is expected in 2015." More than half the year is over. When do you specifically plan to finalize this rule? Will NCUA engage in full cost-benefit analysis prior to finalizing rule and share a detailed description of the methodology employed by NCUA in conducting such analysis?***

NCUA still intends to finalize the risk-based capital rule at an open Board meeting during the last quarter of 2015.

In developing any regulation, NCUA strives to ensure the agency's rulemakings are reasonable and cost effective. While independent regulatory agencies are generally exempt from executive orders on rulemaking, NCUA conducts its rulemaking activities in a manner generally consistent with the philosophy and principles outlined in Executive Orders 12866 and 13563. Both executive orders refer to agencies taking into consideration costs and benefits, both quantitative and qualitative, of a regulation.

Analyses of the various costs and benefits of proposed or final rules and the methodologies used to conduct those analyses are generally developed during the deliberative and rule-writing process, and they are provided to Board members in a variety of ways, including briefings, memorandums, and presentations. These analyses ensure that regulatory choices are made after appropriate consideration of the likely consequences.

Additionally, much of the consideration and weighing of advantages and disadvantages is included in the preambles to the agency's proposed and final rules. Finally, the agency generally tailors regulations in a way that match the affected credit unions' size and complexity, while also providing exemptions or practical alternatives where feasible. For example, the revised proposed rule on risk-based capital exempts non-complex credit unions holding up to $100 million in assets because these credit unions pose limited risks to the Share Insurance Fund.

This deliberative process was undertaken in both of the proposed risk-based capital rules, and it is currently underway for the final risk-based capital rule. As with the proposed rules, the final rule will include a discussion of the benefits of capital in avoiding individual financial institution failures and systemic crises, as well as thorough analyses of the specific changes in capital requirements associated with the final rule and the way those requirements correlate to risks and exposures in the credit union system.

The Board action memorandum accompanying the final rule will provide detailed estimates of NCUA's costs to implement the rule, and that Board action memorandum will be publicly available on NCUA's website.

To provide further information on how NCUA considers the costs and benefits during the development of this and other rules, including pre-decisional matters, NCUA staff are available to brief you or your staff in person.

*e. **Within the rule itself, why are investments in CUSOs risk-weighted at 100 percent, but loans to CUSOs are risk-weighted at 150 percent?***

Actually, the proposed risk weight for an equity investment in a credit union service organization, or CUSO, was 150 percent, while the proposed risk weight for a loan to a CUSO was only 100 percent.

The proposed rationale for the different treatment was that an equity investment in a CUSO is an unsecured, at-risk equity investment. It is, therefore, in a first-loss position, which is analogous to an investment in a non-publicly traded entity. There is no price transparency and extremely limited marketability associated with CUSO equity exposures. In contrast, loans to CUSOs have a higher payout priority in the event of a CUSO's bankruptcy. Therefore, loans to CUSOs warrant a lower risk weight of 100 percent, which corresponds to the base risk weight for commercial loans.

However, based on comments received on the second proposed rule, NCUA is considering reducing the risk weight on equity investments in CUSOs to 100 percent if the credit union's total equity exposure is insignificant.

Please note that the final risk weights will only apply to unconsolidated CUSO loans and equity investments. For CUSOs subject to consolidation under GAAP, the amount of CUSO equity investments and loans will be eliminated from the consolidated financial statements because the loans and investments are intercompany transactions. The related CUSO assets that are not eliminated will be added to the consolidated financial statement and will receive risk-based capital treatment as part of the credit union's statement of financial condition.

*f. **Credit unions are limited to a 1 percent investment in CUSOs. How did this influence your risk-weighting?***

There are statutory limits on how much a federal credit union can loan to and invest in credit union service organizations. However, the limitations are not as stringent for some federally insured, state-chartered credit unions. Also, the limit is only binding for federal credit unions at the time the loan or investment is made. That is, the position can grow in proportion to assets over time.

In setting capital standards like Basel and the standards of the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, the risk of loss—not the size of the exposure—is central to determining the risk weight.

However, as noted in my previous answer, NCUA is considering reducing the risk weight on equity investments in CUSOs if the credit union's total equity exposure is insignificant.

g. ***Why are mortgage servicing assets (MSAs) risk-weighted at 250 percent? Why do you believe this is the appropriate weighting?***

The proposed 250-percent risk weight for MSAs reflected the relatively greater risks inherent in these assets. Specifically, the value of mortgage servicing assets is dependent on an estimated series of cash flows over a period of time. Those values can be very volatile in changing interest rate environments and highly sensitive to unexpected shifts in interest rates, prepayment speeds, and costs associated with servicing. These risks contribute to the high level of uncertainty about the ability of holders of MSAs to realize full value from these assets, especially under adverse financial conditions, and support assigning a 250-percent risk weight. Finally, a 250-percent risk weight for MSAs would maintain comparability with the risk weight assigned to these assets by the federal banking agencies.[5]

h. ***NCUA rules prohibit a federal credit union from purchasing mortgage servicing rights as an investment. [12 CFR § 703.16 Prohibited investments]. If a credit union is servicing its own loans, why then do you require a risk weight?***

Federally insured, state-chartered credit unions are not prohibited under federal regulation from purchasing mortgage servicing assets. Yet prompt corrective action, by federal statute, applies to all federally insured credit unions. Thus, as insurer, NCUA's proposed risk-based capital standards need to account for the activities of all federally insured credit unions, including state charters.

i. ***Your proposal would establish three categories of assets subject to concentration thresholds (consumer loans, equity loans, and mortgages). These requirements don't exist for banks. Why have you proposed doing this this?***

Actually, the revised risk-based capital proposal would subject only two categories of assets to concentration thresholds: residential real estate loans and commercial loans. The proposal does not contain a concentration threshold for consumer loans.

The Federal Credit Union Act requires NCUA to design the risk-based net worth requirement to take account of any material risk. NCUA has historically included concentration risk in the risk-based requirements. Higher capital requirements for concentrations of real estate loans and member business loans exist in the current rule, which the proposal would simplify.

NCUA has been advised by the Government Accountability Office and NCUA's Inspector General to improve how we address credit concentration risk. In 2010 and 2011, NCUA's Inspector General completed several material loss reviews of failed credit unions, citing large real estate loan concentrations as a primary cause of their failure. The failed credit unions held substantial residential real estate loan concentrations in either first-lien mortgages, home equity lines of credit, or both.[6]

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[5] See, for example, 12 CFR 324.32(l)(4)(i).
[6] See *Material Loss Review of Cal State 9 Credit Union*, OIG-10-03 (April 14, 2010); *Material Loss Review of Beehive Credit Union*, OIG-11-07 (July 7, 2011); and *Material Loss Review of Ensign Federal Credit Union*, OIG-10-15 (September 23, 2010). All three reports are available at http://www.ncua.gov/about/Leadership/CO/OIG/Pages/MaterialLossReviews.aspx.

In addition, GAO recommended in 2012 that NCUA address the credit concentration risk concerns raised by NCUA's Inspector General.[7] The GAO report notes credit concentration risk contributed to 27 of 85 credit union failures that occurred between January 1, 2008, and June 30, 2011. The report also indicates that the NCUA Board should revise the agency's prompt corrective action regulation so that the minimum net worth levels required under the rule, including concentration risk, incorporate more forward-looking indicators of risk. Also, the Basel Committee on Banking Supervision has stated that "risk concentrations are arguably the single most important cause of major problems in banks."[8]

NCUA's proposed risk-based capital rule included a tiered risk-weight framework for high concentrations of residential real estate loans and commercial loans. As a credit union's concentration in these asset classes increases, incrementally higher levels of capital would be required. The concentration thresholds would not limit a credit union's lending activity. Rather, the thresholds would require the credit union to hold additional capital to account for the elevated risk.

The inclusion of concentration risk would not put the credit union system at a competitive disadvantage to the banking industry because very few credit unions would be subject to the marginally higher risk weights.

12. ***Chairman Matz, your term expired on April 10 of this year, yet in July you approved a collective bargaining agreement with NCUA's employee union. And the agreement was for five years rather than the standard three.***

    a. ***Why would you seek to bind the agency and your successor in this way? Would it not have been more respectful to sign a shorter agreement and let future leaders of the agency engage in negotiations to meet the needs of the agency at that future date?***

Three-to-five-year agreements are fairly standard in collective bargaining, and the term has to be negotiated. The longer term creates more certainty in future budgets by locking in cost controls.

At the same time, a reopener clause will provide NCUA significant flexibility to renegotiate. The reopener clause allows NCUA management to open up to four articles for renegotiation in July 2017. The union has the same opportunity, so up to eight articles could be open for negotiation at that time.

Also, I'd like to emphasize that each NCUA Board member was briefed by staff before negotiations on the entire agreement and provided multiple opportunities to offer input during the negotiation process. Each Board member will have opportunities to provide further input on the key articles subject to the reopener clause.

[7] See *Earlier Actions are Needed to Better Address Troubled Credit Unions*, GAO-12-247 (2012) available at http://www.gao.gov/products/GAO-12-247.

[8] See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* 214 (June 2006) available at http://www.bis.org/publ/bcbs128.pdf.

This reopener clause provides a new administration the ability to address key articles such as Compensation and Benefits, Hours of Work, and Travel and Expense Reimbursement. This clause also allows a new administration significant flexibility in reshaping NCUA's budget and operation, because compensation, benefits and travel account for over 80 percent of the annual operating budget.

The other budget areas such as contracted services are not impacted by the collective bargaining agreement, so a new administration will be able to promptly establish its own vision for NCUA with complete influence over the budget.

b. ***NCUA claims the agreement is "projected to reduce future cost growth by $17 million, compared to the prior agreement." Please provide the Committee with all records substantiating this claim.***

As outlined below, the projected $17.2 million in cost savings results from reductions in future expense growth gained in the 2015 collective bargaining agreement as compared to the 2011 agreement.

Salaries: Projected Savings of $22.6 Million

NCUA developed a 2015–2020 salary forecast to guide our negotiating strategy. Management modeled the actual staffing data for all 1,171 CU-grade employees as of January 2015 and projected it forward. The 2015 actual base salary total was $102,533,426 and total pay (base pay plus locality pay) was $129,653,040.

For the term of the collective bargaining agreement, the projected cost savings for salaries using the above static factors is expected to be $22,576,393. Following an initial year cost of $71,482 in 2015 to raise the minimum of salary bands, NCUA anticipates savings of $1,433,494 in 2016, $2,013,718 in 2017, $4,591,727 in 2018, $6,001,144 in 2019, and $8,607,792 in 2020.

The baseline comparison projection assumed a General Schedule annual increase of 1.3 percent during the term of the contract. The November 7, 2014, Federal Salary Council report containing the recommended comparability payments for January 2016 was used to calculate annual locality pay calculations. Finally, all of the existing provisions in the 2011 collective bargaining agreement were carried forward.

For the 2015 collective bargaining agreement projection, management modeled all the new provisions involving base and locality pay, including fixed general increases of 1 percent for 2016 and 2017 and 1.25 percent for the remainder of term. The average annual merit increase is 3 percent. Additionally, this forecast includes the new pay cost controls including a continuance of the base pay band caps at all grades from the 2011 collective bargaining agreement, implementing total pay caps, and a lump sum cap for all grade levels that are all at fixed levels during the term of the contract.

This projection also includes the modifications to the calculation of locality pay in the new collective bargaining agreement that slows the growth in this pay component. The result of the following changes compounded over the five-year term of the contract creates much slower locality pay growth, including no growth annually in numerous locality pay areas. The changes include:

- Slowing locality growth with tighter pay bands. As noted above, the net effect saves millions over the contract term but there was an immediate payout of $71,481 in 2015 for the employees below the new pay band minimums.

- Adopting a rolling three-year average (previously the applicable current year) to provide much greater budgetary predictability in the number used to determine the locality adjustment. It cushions NCUA from the experienced sways in the "Disparity to Close" data contained in the annual report of the President's Pay Agent.

- Implementing a multi-tiered category system of locality rate adjustments to rein in the degree of annual locality rate increases.

Benefits: Projected Costs of $4.7 Million

There were three changes to the benefits package that resulted in projected total costs of $4.7 million. These changes related to the health benefits subsidy, the NCUA Savings Plan, and reimbursement for professional licensing.

NCUA estimates that changes to the health benefits subsidy will cost the agency $1.6 million over five years. The subsidy was increased by $10 per pay period. This equates to $260 per year, or $10 multiplied by 26 pay periods per year, per employee. The $260 was then multiplied by 1,250 employees, the estimated employee level during the contract term assuming some level of vacancy in the authorized staffing level. The result is $325,000 per year or $1,625,000 over five years.

NCUA estimates that changes to the NCUA Savings Plan will cost $3 million over five years. It is assumed 93 percent of the employees will participate in the increased savings plan match of 0.5 percent of pay. The estimated salary level of participating employees is $120 million annually. Multiplying this figure by 0.5 percent produces a cost of $600,000 per year or $3 million over five years.

Finally, NCUA estimates that the reimbursement of professional licensing will cost $75,000 over five years. This calculation assumes 30 employees would be eligible to participate in the new reimbursement program at an average license cost of $500 per employee for $15,000 a year or $75,000 over five years.

Leave Carryover: Projected Costs of $50,000

Under the new collective bargaining agreement, the carryover of annual leave increased by 40 hours, which will have a financial impact when employees leave the agency, assuming they are at their maximum leave potential at the time. Looking back at retired employees who were at the maximum leave level when they retired, five employees per year are estimated to receive the additional 40 hour leave payout at $50 an hour. This $2,000 in additional leave payout was then multiplied by five employees for an annual cost of $10,000, or $50,000 over the five-year contract.

Travel Expenses: Projected Costs of $145,000

Under the new collective bargaining agreement, NCUA anticipates that the changes to travel expenses for employees will produce a net value of $145,000 in costs over the next five years.

NCUA anticipates changes in travel voucher submissions will cost the agency $75,000 over five years. This estimate assumes 1,000 additional expense reimbursement requests because the dollar threshold required for submitting them was lowered. Multiplying the cost of $15 per report by 1,000 reports per year over five years yields $75,000.

Changes in the overnight lodging eligibility provisions of the contract will produce savings of $600,000 over five years. The new commute rules reduce employee eligibility for overnight lodging for approximately 100 staff. The calculation assumes three assignments a year that were previously eligible at $400 per assignment, or $1,200 in annual savings per employee. This equates to $120,000 in reduced lodging and per diem charges ($1,200 multiplied by 100 employees). Over five years, this totals $600,000. The $400 savings per assignment assumes $150 for lodging and per diem for the travel reduced by $50 in daily employee mileage for four nights per week.

The changes in mileage reimbursement will produce savings of $275,000 over five years. The new commute rules reduce eligibility for mileage reimbursement when an employee lives more than 40 miles away from his or her duty station. The projection assumes five assignments per year for 100 employees with 40 miles of the daily roundtrip that is not eligible for the mileage reimbursement. So, 100 employees multiplied by 40 miles per day times five days a week for five weeks produces 100,000 in saved mileage each year. When reimbursed at a $0.55 rate per mile, this totals $55,000 per year or $275,000 over five years.

The TSA Pre-Check provisions will cost NCUA an estimated $85,000 over five years. The cost of TSA Pre-Check is $85 for a five-year clearance. There are 1,000 employees eligible based on their travel status for the agency, which equates to $85,000 (1,000 x $85) during the contract term. There is expected savings to the agency that is not factored due to less wait time at the airport for employees. This results in less lost productivity from traveling. If each employee saves two hours of travel and wait time over five years at $50 per hour, this program will be profitable for the agency, but we stayed conservative in our estimate and did not factor the increased productivity.

The supply stipend provisions will cost $75,000 over five years. Field staff are not provided supplies so they are provided a stipend that allows them to outfit their remote and virtual offices. The new collective bargaining agreement increased the 2015 allotment by $200. For calculations, it is assumed 50 percent of the 750 field staff would spend the additional funds. So, 375 employees multiplied by $200 equals $75,000.

The subscription stipend provisions in the new collective bargaining agreement will cost \$10,000. Field staff were previously authorized a stipend for professional subscriptions. The stipend was increased by \$20 per year under the new contract. It is assumed 100 employees will use this increased stipend, for a total cost of \$10,000, or \$20 a year for five years multiplied by 100 employees.

The contract's provisions to increase laundry service reimbursements while traveling will raise costs by \$25,000. Staff traveling five or more consecutive nights are now authorized up to \$15 on the trip for laundry service. This is an increase of \$5 per trip over the old contract. It is assumed 1,000 laundry claims at the \$5 increase over five years, or \$25,000.

The new collective bargaining agreement eliminated the gain-sharing program to produce savings of \$1.5 million over five years. The gain-sharing program produced a net annual cost of approximately \$300,000 to NCUA, but it did not change travel patterns of the employees. As a result, NCUA negotiated the elimination of the program in the new collective bargaining agreement. Over the five-year contract, NCUA will save \$300,000 annually for five years, or \$1.5 million.

The collective bargaining agreement's provisions on lodging-nights compensation will increase costs by \$2.25 million. NCUA plugged actual lodging-nights claims for 2014 and 2015 year-to-date into the new tiered structured to arrive at an annual expected cost increase of \$450,000 a year. Multiplied over five years, this results in an estimated cost of \$2.25 million.

Principal Examiner Certification Program: Projected Costs of \$100,000

The new collective bargaining agreement authorized an additional eight hours of preparation time for the principal examiner certification program. It is assumed 50 examiners per year will use the eight additional hours for 400 hours a year. At \$50 per hour, the total cost is \$20,000 a year or \$100,000 over 5 years.

Employee Relocation: Projected Costs of \$375,000

The new collective bargaining agreement increased the market-loss differential payout for employees relocating to Washington, D.C. The average cost is \$37,500 per employee. Assuming two employees per year will relocate to positions in NCUA's central office and request a market-loss reimbursement, this amounts to \$75,000 per year or \$375,000 over five years.

Other Efficiencies and Savings

There will also be increased efficiencies and productivity in the new agreement that are not included in the \$17.2 million estimate. For example, the revised telework program requires staff to work remotely during a federal government closure caused by inclement weather or other circumstance. This is projected to increase productivity by \$1.2 million over the contract term. Similarly, the commute requirements have been revised for remote and virtual staff, and it is anticipated that will improve productivity and reduce travel costs. Both matters are discussed below.

Commute and Travel Time: Unable to Quantify Projected Savings

There were significant changes to the requirements for staff to absorb uncompensated commute time, but there are too many variables to make a reasonable projection with any level of confirmation. It was therefore not included in the estimated value of projected savings.

Telework: Projected Productivity Increase Valued at $1.2 Million

NCUA anticipates that the new collective bargaining agreement will produce $1.2 million in savings over five years because of increased employee productivity. To increase productivity, the new agreement requires telework-ready employees to work when the federal government closes. Each D.C. federal government closure caused by weather or other event results in a loss of approximately 1,600 hours of staff productivity. This assumes 200 people are working in the headquarters office on any given day for eight hours. Assuming an average salary of $50 per hour, the daily cost of lost productivity is $80,000, or $50 multiplied by 1,600 hours. Assuming three federal closures per year, this amounts to $240,000 per year or $1.2 million ($240,000 multiplied by 5) over a five-year contract.

To provide more information about how NCUA calculated these estimates as well as background documents, NCUA staff are available to brief your staff in person at your request.

c. ***During collective bargaining negotiations, what union demands did you not grant? What requests did you decline? Please provide a list of all proposals not granted by NCUA.***

During the negotiations, the requests not granted or materially modified include:

- Provide employees a merit increase ranging from 2 to 4 percent in year one with a 50 basis point increase each year thereafter, so by the end of year five of the collective bargaining agreement the merit range would be 4 to 6 percent per year.

- Adjust the pay bands each year by the level provided to General Schedule employees and add that adjustment amount to employee base pay.

- Set locality increases with an upward range of 8 percent annually.

- Grant promoted employees a minimum 14 to 16 percent raise.

- Establish an NCUA-funded disability insurance program.

- Allow all employees who travel more than 75 nights a year the option for a fully reimbursed weekend trip home when on a multi-week assignment without a cost justification.

- Allow automatic approval of rental cars when the employee travels at least 250 miles to the assignment.
- Eliminate the requirement to share rental cars when at an assignment with multiple employees.
- Establish taxi or car service as the standard transportation method for travel from a residence to a transportation terminal such as an airport.
- Reimburse employees in overnight travel for the first and last day based on a quarter-day system instead of the standard 75-percent reimbursement average.
- Reimburse up to $20 for laundry service when on an overnight assignment covering at least five days.
- Expand the types of eligible assignments that count towards the annual travel nights lodging compensation program. The eligibility thresholds would change to a range of $60 to $200 per night after reaching 61 days in overnight status.
- Provide ongoing lists of all bargaining unit meeting attendees to NTEU.
- Provide all data to NTEU on surveys conducted.
- Provide NTEU officials with compensated time for travel associated with union business.
- Allow NTEU officials to receive a full merit raise based on the prior year appraisal rating even if they did not work a minimum number of productive hours.
- Commit to various minimum buckets of hours for defined tasks and authorize staff to carry unused buckets of hours to future months.
- Provide employees administrative leave when working in an "affected area" and the government in that area has not closed in instances where field or remote employees are unable to work due to the local conditions.
- Jointly select with NTEU a new travel management tool for booking government travel.
- Incorporate a gain-sharing program into the collective bargaining agreement.
- Provide NTEU with an explanation anytime there is a decision to expand the applicant pool to external candidates when NCUA considers external candidates for a vacancy.
- Provide NTEU with a copy of all decisions on requests for part-time employment.

- Implement a phased-retirement program within 60 days of the effective date of the new collective bargaining agreement. The proposal included the employee having sole discretion to participate in the program and also deciding whether to return to full-time status while in the program.

- Eliminate the standardized testing process for promotion to the CU-12 principal examiner position.

- Give priority consideration to bargaining unit employees when considering the pool of candidates for a reassignment.

- Establish a joint labor-management working group to revise the performance management system.

- Provide NTEU with meeting space in the headquarters and regional offices for all non-duty hours requested.

- Allow the use of NCUA's email system to announce or conduct internal NTEU business.

- NCUA and NTEU will mutually agree on the location of the union onsite office.

13. ***Chairman Matz, page 26 of your annual report touts your participation on FSOC, and says that this participation has "broadened NCUA's perspective."***

    a. ***How do you define systemic risk?***

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides guidance. This section authorizes the Financial Stability Oversight Council to determine that a nonbank financial company shall be supervised by the Board of Governors of the Federal Reserve System and shall be subject to prudential standards, in accordance with Title I of the Dodd-Frank Act, if the Council determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States.

The Council's Final Rule on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies also notes that the Council considers a "threat to the financial stability of the United States" to exist if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy.

This definition should be distinguished from the use of the same term within NCUA. The term "systemic risk" is used within NCUA to define those credit unions assigned to the Office of National Examinations and Supervision. These very large credit unions, while not systemically important to our nation's financial system, are systemically important to the National Credit Union Share Insurance Fund and receive greater scrutiny.

b. What is your definition of too-big-to-fail?

"Too-big-to-fail" is a term frequently used to refer to firms that are so large and or interconnected that their failures would have systemic consequences. These firms are referred to as "too-big-to-fail" because it is presumed that the government would take extraordinary actions to avoid the failure of these institutions.

c. Does too-big-to-fail still exist?

I believe that there are large, interconnected financial firms whose failures would pose critical systemic consequences.

d. Given your experience at FSOC, in your view, would the failure of any single credit union threaten the financial stability of the United States?

I do not believe that the failure of any single credit union would threaten the financial stability of the United States. However, there are credit unions that are large enough that their failures would have a consequential effect on the stability, growth, and lending capacity of the credit union system and the National Credit Union Share Insurance Fund. At the same time, it is clear that disruptions in the broader financial system can have an enormous impact on credit unions, and my participation on the Financial Stability Oversight Council has expanded my access to information about the potential for financial distress in the United States.

e. What data and analysis did you rely on to inform your decision to designate Prudential as a systemically important institution? What specifically is it about Prudential that makes it different in kind from other large insurance companies?

FSOC publishes a public basis for each designation. These documents summarize data and analysis used in the designation process.[9]

Following the guidance that has been laid out, the focus of the Council in our designation decisions has been on the direct and indirect exposure of financial market participants to each company, as well as the potential impacts of a sudden need to liquidate assets, and the potential difficulty of an orderly winding down of the institution in the event of its failure. The Council also considers whether a nonbank financial company provides a critical function or service that is relied on by financial market participants for which there are no ready substitutes.

f. How about GE Capital? What factors let you to conclude that GE Capital is a SIFI?

As noted above, FSOC publishes a public basis for each designation. These documents summarize data and analysis used in the designation process.[10]

Following the guidance that has been published, the focus of the Council in our designation decisions has been on the direct and indirect exposure of financial market participants to each

[9] See http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.
[10] See the same link as noted in footnote 9.

company, as well as the potential impacts of a sudden need to liquidate assets, and the potential difficulty of an orderly winding down of the institution in the event of its failure. The Council also considers whether a nonbank financial company provides a critical function or service that is relied on by financial market participants for which there are no ready substitutes.

g. ***Do you have a background in insurance? On whose expertise did you rely in advising you on these matters?***

I do not have a background in insurance, but I have a deep background in understanding the risks in employing funds to earn a return in financial markets. Although credit unions and insurance companies appear to be very different institutions, both create value by managing the risk of their assets and liabilities. The channels through which distress at insurance companies would transmit or amplify risk have mostly to do with the interconnections and exposures to other financial institutions, rather than insurance operations.

By design of the Council, each member brings a unique perspective to the designation process, informed by our particular areas of expertise and experience. In my case, that is a multi-decade career in and around the financial services industry and the experience of leading an agency through the aftermath of the financial crisis. The Council structure adopted by the Dodd-Frank Act ensures that a broad array of views are considered in making designation decisions.

I take my responsibilities very seriously. As a voting member, I consider all the evidence provided by the analytical team, as well as the discussions I've had with other principals, and the information submitted by the firms and the in-person hearing at which the designated firm may participate. During the designations process, I was routinely briefed by NCUA staff who were involved in the overall FSOC analysis and in developing many drafts of the FSOC analysis.

h. ***Did you visit any of the companies designated by FSOC prior to your vote? Did you meet with the company's management?***

I met with representatives of Prudential and MetLife prior to the final designation vote, following the procedures the Council had adopted.

i. ***Do you have an insurance expert on staff at NCUA? Who?***

Like the Federal Deposit Insurance Corporation is for banks, NCUA, is the insurer of credit union deposits, maintaining the National Credit Union Share Insurance Fund. Therefore, NCUA does have experience and expertise in providing share insurance for credit unions.

While NCUA does not have individuals on staff with experience underwriting other types of insurance products, the agency does have experts in asset-liability management, capital markets activity, interest rate risk, and derivatives. The designation issues presented to the Council about insurance companies were, for the most part, about their connections and exposures to other financial institutions.

j. How does insurance company business model differ from that of large national bank or a credit union?

The insurance company business model differs from credit unions and banks in many dimensions, including: purpose, chartering and regulation, capital, and liquidity requirements and needs.

It is worth noting, however, that there are broad similarities between aspects of the insurance company business model and the business models of credit unions and banks. Each must manage credit risk, operational risk, and conduct liability and receivable valuations over longer time periods based on modeling. Credit unions and banks also must manage the risk of having longer-maturity loans and investments as assets paired with term deposits, on-demand deposits, and other short-term liabilities. In other words, they engage in sophisticated asset management techniques. Insurance companies also engage in sophisticated asset management techniques and are facing the same broad financial market developments faced by credit unions and banks.

k. The sole voting member with actual expertise in insurance was the sole dissenting vote in FSOC's decision to designate MetLife and Prudential. What is it in particular that you found unpersuasive with his arguments against designation?

I have a deep respect for Mr. Woodall and, for that matter, all of the FSOC principals. Given the wealth of material the Council studied—a final basis for each company that ran at between 200 and 400 pages—I can appreciate how different people with different backgrounds could see the same material and reach different conclusions. It is worth noting that in the Council's review it was not the straightforward insurance operations that triggered the designations. Rather, it was their large size and highly interconnected deployment of financial assets, along with the potential for a difficult and disorderly unwinding in the event of failure. My conclusions on these two designations, after reviewing all the available evidence, were in line with the majority on the Council: that material financial distress at these companies could pose a threat to U.S. financial stability.

14. ***The FSOC also has the authority to designate activities and non-banks as systemically important.***

a. How many NCUA employees are experts on industries and financial policy matters beyond the regulation of credit unions?

Credit unions face many of the same challenges that face banks and other financial institutions that participate in credit markets. Credit unions use many of the same financial market analyses used by banks and other financial institutions that participate in credit markets. As such, many NCUA employees—through their everyday work—have a deep understanding of the financial policy matters that are common to financial institutions that, among other activities, take in deposits, make loans, or otherwise manage their assets by participating in credit markets.

Further, many NCUA employees have considerable financial market experience, both from employment in the private sector and in other government agencies such as the Federal Reserve, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and the Department of the Treasury. They bring this experience to bear on credit union issues primarily, but their knowledge, experience and training enables them to understand and comment knowledgably on a wide variety of financial policy issues beyond the regulation of credit unions.

b. Which agency is the primary regulator of asset managers?

The Securities and Exchange Commission is the primary regulator of the securities industry.

c. How many NCUA employees are asset manager experts?

Many NCUA employees—through their everyday work—have a deep understanding of asset management concepts and applications. Understanding asset management is a key element in understanding the safety and soundness of individual credit unions. For example, within the central office, NCUA has a division of capital and credit markets staffed with seven experts in asset management. There are many others throughout the agency with extensive knowledge of asset management.

d. Are you aware of the comprehensive and onerous rules and regulations required by the securities laws and the SEC?

I am aware that the Securities and Exchange Commission is a key regulator of the securities industry.

e. Do you believe asset managers are systemically risky? How so?

It is impossible to answer that question directly. The asset management industry is extremely diverse. It comprises institutions and activities ranging from money market mutual funds, to mutual funds, to hedge funds, and to private equity funds.

In many instances, asset managers act primarily as agents. They manage assets on behalf of clients as opposed to investing on their own behalf. For these entities, losses are borne by—and gains accrue to—clients rather than the asset management firm. At the same time, I understand that there are other entities that both manage funds and share in the gains and losses.

Partly because the industry is so diverse, and following our outreach to and comments from the industry, FSOC principals directed staff to focus on analyzing asset managers' products and activities. As I noted in my answer to questions at the hearing, asset management activities remain an area of ongoing inquiry by FSOC.

The Council has not made any determination about the potential risks to financial stability arising from asset management products or activities. I am reserving judgment on this issue pending additional briefings and Council deliberations.

f. Can you name specific asset managers that are of concern to you as Chairman of the NCUA?

It is not appropriate for me to comment on specific firms. At the same time, it is worth emphasizing that, with respect to the asset management industry, FSOC is currently focusing on industry-wide products and activities to assess potential risks in the asset management industry, rather than individual firms.

g. Do you believe the SIFI designation should be examined at the entity level or more focused on activities? Why?

Right now, the designation as a systemically important financial institution can only be applied to entities, not to specific activities. With respect to the wide array of institutions predominantly engaged in financial activities, it is impossible to draw a hard and fast line. Within the scope of the asset management industry, however, following outreach and comments from the industry, FSOC principals directed staff to focus on analyzing products and activities. So, that is our current focus in the area of asset management. The current focus reflects our judgment that, because many asset managers are engaged in many different activities, it is useful to try to distinguish activities and products that may add substantial risk from those that pose little or no risk.

h. Last year, the Committee received testimony that a SIFI designation for asset managers would result in more than a $100,000 in costs to each investor with an account at a mutual fund. Do you believe that is an acceptable cost for investors to bear?

That does seem like a very high cost, but I am unfamiliar with the estimate and how it was derived.

i. In 2014 and again on July 20, 2015, Barney Frank stated that he did not believe asset managers should be regulated as SIFIs. Do you disagree with Mr. Frank?

I certainly respect the views of Chairman Frank. Because I share his concerns about designating asset managers, I supported narrowing FSOC's focus to studying products and activities across the industry.

In addition, it is important to understand that the financial system is always evolving. FSOC must remain alert to the changing nature of emerging activities and companies, rather than relying on hard and fast rules that may become outdated over time.

j. Do you believe that any action taken by FSOC to designate asset managers or their activities as systemically important would be inconsistent with the congressional intent of Dodd-Frank?

No.

k. Do you believe that you are qualified to vote on a regulatory matter outside of the NCUA's expertise? Why?

Yes. By the design of the Council, each member of FSOC brings a unique perspective to the designation process, informed by our particular areas of expertise and experience. In my case, that is a multi-decade career in and around the financial services industry and the experience of leading an agency through the aftermath of the financial crisis, which includes the successful resolution of corporate credit unions with nearly $50 billion in distressed assets. The Council structure that the Dodd-Frank Act adopted ensures that a broad array of views are considered in making designation decisions. I take my responsibilities very seriously.

l. What are the specific differences between asset managers and other financial firms?

There are many differences between asset managers and other financial firms.

While there are many types of asset managers, they share the common characteristic of managing financial assets on behalf of investors. Asset management activities include allocating assets and selecting securities, using a variety of investment strategies in registered and non-registered funds, enhancing returns with derivatives or leverage, and creating customized investment solutions for larger clients, primarily through so-called separate accounts. For many asset managers, the losses and gains on the financial assets are incurred by the client of the firm rather than the firm itself, though there are asset managers that also share in the gains and losses of the funds they manage.

The general characteristic of asset managers is different from other financial firms whose shareholders benefit from the gains on investments made by its managers and suffer losses when investments decline in value. While other financial firms are required to hold capital to cushion against a decline in the value of their assets to ensure the firm will be able to meet its liability obligations, asset managers hold little capital because, for many types of asset managers, it is the investor rather than the firm that bears the losses.

At the same time, asset managers and other financial firms face similar challenges. They both need to ensure cash flows are sufficient to cover any liquidity need as it arises. Some forms of asset managers may create funds that can be close substitutes for the money-like liabilities created by banks; many engage in various forms of liquidity transformation, primarily, but not exclusively, through collective investment vehicles; and they provide liquidity to clients and to financial markets. An unexpected decline in cash flows that can originate from a multitude of sources will negatively impact any financial firm. When the decline in cash flows are significant enough, it can result in the firm trending toward illiquidity or insolvency. Any large, interconnected financial firm with the need to sell into an illiquid market could be a source of systemic risk.

m. ***What are the revenue streams for asset managers and how they are different from other financial institutions?***

Asset managers generally hold financial assets on behalf of investors and receive revenue by charging a fee for the financial services they provide. The fee structures for asset managers are as diverse as the variety of services they provide. Generally, fees may be a set amount for a period of time, they may be assessed on a per service basis, or they may be a percentage of assets under management. A common fee structure for hedge funds includes a share of any gains in asset value. Asset managers may use any or all of these fee types.

Other financial institutions, primarily depository institutions, generate revenue through accepting deposits and paying interest on them, while lending out the deposited funds at a higher interest rate. Depository institutions also generate revenue through a variety of fees, usually related to the provision of a service, such as mortgage refinancing or bond issue underwriting.

n. ***Does a stand-alone asset manager have access to central bank liquidity?***

No. However, during the financial crisis, it became necessary to provide a temporary guarantee program to protect shareholders of money market mutual funds to help maintain financial stability.

o. ***How many asset managers were among the 700 U.S. financial institutions that received a direct investment under the TARP Capital Purchase Program?***

No asset managers received assistance through the TARP Capital Purchase Program.

p. ***As you are aware, the SEC published for comment the OFR's report on asset managers. Many comments were received, including one by Commissioner Gallagher that noted the report was "fundamentally flawed" and that the resulted of the OFR not only "inaccurately defined and described the activities and participants in the assets management business," but also analyzed the purported risks posed by assets managers in a "vacuum instead of in the context of the broader financial markets." How can you—as a voting member of FSOC—determine an asset manager is a SIFI based on inaccurate information?***

In examining the potential for financial instability, FSOC decided to study the activities of asset management firms to better inform its analysis of whether—and how—to consider such firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act. The Council asked the Office of Financial Research, in collaboration with FSOC members, to provide data and analysis to inform this consideration.

The report produced by the Office of Financial Research responded to that request by analyzing industry activities, describing the factors that make the industry and individual firms vulnerable to financial shocks, and considering the channels through which the industry could transmit risks across financial markets. The report was useful in summarizing aspects of the asset management industry and as guide for developing a framework for further research and analysis. In particular, the comments received about the report were instrumental in narrowing the focus of further work on asset managers to activities and products.

As a follow-up to the report, FSOC hosted a conference on the asset management industry and its activities to help inform its ongoing assessment of potential risks to U.S. financial stability. During the conference, practitioners—including CEOs, treasurers, and risk officers—as well as academics and other stakeholders discussed a variety of specific issues that relate to the industry. There were more than 15 major presentations, from a variety academics and industry participants. These discussions and presentations were very useful in helping the Council to narrow its focus on activities and products.

The Office of Financial Research report on asset managers was never intended to be a definitive source of information for designation of any firm. The path to designation, if it were to occur at all for an asset manager, would follow the procedures adopted by the Council in February 2015, which would require a thorough analysis of the firm. This, again, if it were to occur, would entail extensive documentation and analysis, as well as opportunities for the firm to meet with FSOC staff and decision-makers.

q. ***What is a qualified custodian?***

With certain limited exceptions, an investment adviser is required to maintain client funds and securities with a "qualified custodian." Qualified custodians can be banks, registered broker-dealers, futures commission merchants, or certain foreign entities. A qualified custodian either maintains client funds and securities in a separate account for each client under that client's name, or in accounts that contain only client funds and securities under the name of the investment adviser as agent or trustee for the clients.

NCUA's Stress-Testing Rule

a. ***Did Dodd-Frank require the NCUA to issue a stress-testing rule?***

The Dodd-Frank Act did not require NCUA to issue a rule on stress testing. During the most recent recession, however, several large insured credit unions failed, imposing a significant strain on the Share Insurance Fund and corresponding insurance assessments on federally insured credit unions. In response, the NCUA Board approved a regulation to require stress testing for the largest credit unions as a prudent measure to prospectively assess risk and reduce losses to the Share Insurance Fund.

b. ***NCUA's stress testing rule requires any credit union with over $10 billion in assets to undergo stress testing. Currently there are only five such credit unions, and they already voluntarily engage in internal stress testing. Why can't NCUA take the results of their internal testing and independently verify the results? Why require such duplication?***

Because the Share Insurance Fund is $12.1 billion, each of these credit unions is almost as large as or larger than the entire fund. The failure of one of these institutions could significantly affect the entire credit union system.

With that in mind, the NCUA Board voted unanimously in April 2014 to take the additional step of requiring independent stress testing for these credit unions. This is the result of the credit union system's experience with corporate credit union failures during the Great Recession. At that time, NCUA had largely relied on credit union-derived risk analysis, which was later discovered to be lacking conservative assumptions and analytical techniques appropriate for risk management. We have since embraced an approach of conducting independent stress tests in an effort to uncover prospective risks and to ensure our largest institutions are better prepared to withstand difficult economic environments.

NCUA's results were not duplicative of credit union results, because only one credit union had been performing stress testing at the time of the rule's implementation. It should be noted that this credit union has over $50 billion in assets and would be subject to Federal Reserve Board-run stress testing if it were a bank holding company.

c. ***Does NCUA lack the capacity or expertise to independently verify the internal stress testing conducted by these five credit unions?***

NCUA does not presently have the calculation capacity to run stress tests, nor does it have access to industry performance data that drives projected performance results. Accordingly, the agency engaged an industry expert, BlackRock Solutions, to fulfill these responsibilities. NCUA is exploring whether it would be cost effective and efficient to assume these functions within the agency over time while maintaining an independent assessment of credit union risks.

NCUA does have the internal expertise to design and manage the stress testing project, direct the contractor on critical decision points concerning model assumptions and analytical approaches, and evaluate the impact of assumptions and methods. NCUA also can perform quality assurance on the third-party stress test results.

d. ***Is the cost of stress testing paid for out of the Share Insurance Fund? If so, how much? What is the annual cost?***

Yes, the cost is paid out of the Share Insurance Fund. The cost was $2.3 million in 2014 and $1.7 million in 2015. The annual cost will continue to decline each year under the current contract.

e. ***The NCUA has contracted out its stress testing work. Who did you hire? Why were they necessary to hire?***

Through a competitive bid process, NCUA contracted with an industry expert, BlackRock Solutions, to conduct stress tests on each of the five credit unions with assets over $10 billion. Although NCUA staff have experience conducting stress tests and are capable of supervising the stress testing process, NCUA is not equipped with the computational and data resources required to complete robust stress tests. BlackRock was contracted to work with NCUA on development of robust models with appropriate predictive capabilities, acquisition and cleansing of credit performance segmented by retail loan products, and acquisition of necessary quantitative tools. NCUA tapped BlackRock's experience in similar stress test exercises to consider alternative methods and to inform sound model techniques based on likely changes in institutions' strategies.

NCUA explored the costs associated with conducting stress tests using its own resources, through adding staff and procuring industry data and analytical software. This approach would be cost prohibitive.

f. Why does the NCUA lack the in-house expertise to conduct stress testing?

Acquiring in-house expertise to conduct stress testing would have required substantial increases in the NCUA staff and budget. In April 2014, the NCUA Board determined that the benefits of stress testing the five largest credit unions would be outweighed by the costs of doing so in-house. The Board instead directed staff to begin the stress testing program through a competitive bidding process. The contractual arrangement has proven to be more cost effective than an in-house program would have been in the initial phase.

NCUA is utilizing external expertise and computation resources in the first three years of stress testing both to expedite the implementation of NCUA's stress testing rule and to assimilate external experience of stress test applications. As noted earlier, NCUA is exploring whether it would be cost effective and efficient to assume these functions within the agency in the future.

In the meantime, NCUA has the internal expertise to manage the project, direct the contractor on critical decision points, and perform quality assurance on the stress test results.

g. Please share copies of these contracts and related task orders with the Committee.

NCUA will provide these materials in the near future. NCUA staff is also available to discuss these contracts if you have additional questions.

15. Chairman Matz, your November 2014 budget statement indicated that the NCUA uses zero-based budgeting and that it means "every position and every expense must be individually justified."

a. Please provide the NCUA analyses that show how it uses zero-based budgeting.

The Chief Financial Officer describes the process used to develop NCUA's budget in the annual Board action memorandum on the budget, which is available in the budget resource center on the NCUA website.[11] The Board action memorandum outlining NCUA's 2015 budget is attached. In summary, it states that all 21 regional and central offices develop budget requests identifying resources required to support NCUA's mission and strategic goals and objectives. These budgets are developed using zero-based budgeting techniques to ensure each office's requirements are

[11] See http://www.ncua.gov/about/Pages/budget.aspx.

individually justified and consistent with the agency's overall multi-year strategic plan and annual performance plan, which are posted on the NCUA website.[12]

Offices do not simply start with last year's approved budget and request increases based on previously approved dollar amounts. Instead, offices are required to justify every dollar anew.

One of the primary inputs in the budget development process is a comprehensive workload analysis that captures the amount of time necessary to conduct examinations and supervision of federally insured credit unions to carry out NCUA's dual mission as insurer and regulator. This process starts with a field-level review of every credit union to determine the number of workload hours needed for the budget year. The workload estimates are refined by each level of management in the field program until the final budget proposal is completed and forwarded to the central office for review and analysis. The final workload analysis establishes the foundation for NCUA's five regional office budget requests and for the Office of National Examinations and Supervision. Together, these offices represent 72 percent of NCUA personnel.

In addition to the field workload analysis, which is used to develop personnel and travel costs, all field offices develop cost estimates for fixed and recurring items such as rent or leased property, operations and maintenance, facilities repairs, supplies, telecommunications, and other administrative and contracted services costs. Central offices undertake similar budgeting tasks.

All office budget submissions within NCUA undergo thorough reviews by the responsible regional and central office directors, the Chief Financial Officer, and executive leadership. NCUA's Information Technology Prioritization Council meets with regional and central offices to review and prioritize software and hardware initiatives and align these information technology investments with NCUA's mission. These multi-level reviews result in a mutually agreed-upon budget to support NCUA's top priorities: implementing a robust supervision framework, promoting awareness of critical risks and related threats, developing financial literacy and consumer protection programs, providing guidance to credit unions, and strengthening security programs.

A two-page fact sheet describing NCUA's budget process and its zero-based, bottom-up approach is posted to our website in the budget resource center and is included for your review.

b. ***Please provide individualized justifications prepared by NCUA prior to adoption of NCUA's most recent budget evaluating salary levels for the following positions:***

i. ***Executive Director***
ii. ***Deputy Executive Director***
iii. ***General Counsel***
iv. ***Chief Economist***
v. ***Chief Financial Officer***
vi. ***Chief Information Officer***
vii. ***Director of the Office of Consumer Protection***
viii. ***Director of the Office of National Examinations and Supervision***

[12] See http://www.ncua.gov/Legal/RptsPlans/Pages/SP-APB.aspx.

ix. ***Director of the Office of Examination and Insurance***
x. ***Director of the Office of Human Resources***
xi. ***Director of the Office of Minority and Women Inclusion***
xii. ***Director of the Office of Public and Congressional Affairs***
xiii. ***Director of the Office of Small Credit Union Initiatives***
xiv. ***Director of the Office of Continuity and Security Management***
xv. ***President of the Asset Management and Assistance Center***

As required by law, NCUA must maintain pay comparability with the other Financial Institutions Reform, Recovery, and Enforcement Act agencies, commonly referred to as FIRREA agencies.[13] The most recent analysis of comparability showed NCUA is comparable, but in many cases below, the other FIRREA agencies' compensation levels.

NCUA has a long-standing pay-for-performance system and policy where the pay levels of individuals are adjusted based on the evaluation of their performance each year. This is consistent with the process followed in setting the 2015 pay of all Senior Staff Positions (SSPs), including those listed above. Thus, any annual salary increases for these positions are justified by performance appraisals, which are confidential.

The structure of the SSP grades was overhauled in December 2009, when the highest grade level of SSP-4 was eliminated. The positions and structure were evaluated again in December 2013. Of the positions listed above, both evaluations set the positions of Executive Director, Deputy Executive Director, General Counsel, Director of the Office of Examination and Insurance, and Director of the Office of National Examinations and Supervision at the grade level of SSP-3. All other positions on the list are at the SSP-2 level.

The current salary caps at the SSP-1 and SSP-2 levels were adjusted in December 2013, while the total pay for the SSP-3 level (the maximum salary for any NCUA employee) remains unchanged since 2008.

16. ***According to NCUA figures in the Share Insurance Fund annual report, roughly $130 million in operational expenses are taken out of the Share Insurance Fund annually. These are funds earmarked to cover losses when credit unions fail, and are paid in by assessments of the credit union industry.***

Please provide the Committee with an itemized breakout of how much has been taken out of the NCUSIF over the past five years, with line items for individual expenses.

Pursuant to section 203 of the Federal Credit Union Act, NCUA only charges the Share Insurance Fund for charges attributed to NCUA's insurance-related operations. Thus, Share Insurance Fund expenses are primarily operating expenses for insurance-related activities—that is, examination procedures that address safety and soundness issues—supported by salaries, benefits, travel, contracted services, and administrative expenses.

[13] See 12 U.S.C. 1766(j)(2)

Based on quantitative data that demonstrated the percentage of examiners' time dedicated to insurance-related activities, the NCUA Board in November 2014 approved the current overhead transfer rate of 71.8 percent for the 2015 budget cycle. This overhead transfer accounts for approximately 98 percent of the Share Insurance Fund's expenses. An overview analysis of the overhead transfer rate for the last five years follows:

Budget ($ thousands)	2011	2012	2013	2014	2015
Operating Fund Budget	$225,404	$236,855	$251,387	$268,290	$279,478
Overhead Transfer Rate	58.9%	59.3%	59.1%	69.2%	71.8%

To provide greater transparency related to the setting of the overhead transfer rate, as part of my testimony during the hearing, I stated my intent to call for an NCUA Board vote to publish the overhead transfer rate for comment every three years in conjunction with the consideration of the agency's strategic plan. In August, I subsequently announced that we would also invite comment on the federal credit union operating fee. Accordingly, the NCUA Board will vote in January 2016 to publish both the overhead transfer rate and the operating fee methodologies in the *Federal Register*.

The Share Insurance Fund may also fund certain costs directly. These funding items have been requested and approved in several Board action memorandums or pursuant to NCUA Board-approved delegations. Most recently, the Share Insurance Fund has funded the following special initiative projects in 2014 and 2015:

- Stress testing of credit unions with over $10 billion in assets by the Office of National Examinations and Supervision—Actual cost of $4 million through June 30, 2015;
- Federal credit union derivatives authority—Total estimated cost of $1.5 million through 2015;
- Credit Union Service Organization Registry—Total estimated cost of $1.4 million through 2015; and
- Contracted audit support services to support Share Insurance Fund financial statements—Total estimated cost of $520,000 in 2015.

The NCUA website has a dedicated page for Share Insurance Fund reports and statements.[14] The monthly financial highlight reports and the quarterly presentations at the open NCUA Board meetings are all archived and available. NCUA also maintains a monthly accounting of the Operating Fund on its website, and the most recent report for the Operating Fund is attached for your review.[15]

The table below outlines the expenditures of the Share Insurance Fund over the past five years. At your request, NCUA staff are available to answer additional questions about these expenditures and provide more information.

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[14] See http://www.ncua.gov/DataApps/Pages/SI-Reports.aspx.
[15] See http://www.ncua.gov/Legal/RptsPlans/Pages/OPFund.aspx.

Share Insurance Fund ($ thousands)	Notes	2011	2012	2013	2014	2015
Operating Fund Budget	(a)	$225,404	$236,855	$251,387	$268,290	$279,478
Overhead Transfer Rate (OTR)	(a)	58.9%	59.3%	59.1%	69.2%	71.8%
Costs Incurred Pursuant to OTR	(b)	$129,986	$137,528	$146,009	$175,592	$200,000
Stress Testing Large Credit Unions	(b)	-	-	-	$2,300	$1,700
Federal Credit Union Derivatives Authority	(b)	-	-	-	-	$1,500
Credit Union Service Organization Registry	(c)	-	-	-	-	-
Contracted Audit Support Services	(b)	$855	$2,071	$794	$535	$520
State Supervisory Authorities (SSA) Training-Related Travel	(d)	$977	$1,372	$1,232	$1,136	$779
SSA Computers	(d)	$242	$109	$140	$138	$109
SSA National Institute for State Credit Union Examination	(d)	$74	$74	$76	$79	$61
Bank Fees and Other Misc. Items		$224	$83	$61	$38	$41
Total		$132,358	$141,237	$148,312	$179,818	$204,710

(a) Represents budgeted amounts.
(b) Amounts for 2015 are estimates; prior years are actual amounts. Costs charged pursuant to OTR reflect OTR rate applied to actual Operating Fund expenditures.
(c) Credit Union Service Organization Registry cost is a capital expenditure and does not flow through Operating Expenses. Actual 2014 and budgeted 2015 costs are $128,000 and $1,272,000, respectively.
(d) State Supervisory Authorities-related costs. Annual actual expenses with 2015 through September 2015.

17. NCUA's budget report says contracted services are now $26.2 million, up 9 percent ($2.1 million) over last year.

a. Why is it that each division within NCUA has its own contracting officer? Why not manage contracting through a central procurement office?

Actually, NCUA does have a central procurement office. The Division of Procurement and Facilities Management within NCUA's Office of the Chief Financial Officer centrally manages the contracting function. The division has four warranted contracting officers who procure services and supplies on behalf of the central and regional offices. Moreover, the authority to serve as the NCUA contracting officer is delegated by the NCUA Board to the Director of the

Division of Procurement and Facilities Management. No other divisions within NCUA have contracting officers.

The NCUA Board delegated limited purchasing authority to NCUA regional directors and the president of the Asset Management and Assistance Center (AMAC) for normal operation of their respective offices. Generally, this purchasing authority is limited to $20,000 and is similar to that found in other agencies for non-warranted ordering officials. Actions that exceed the purchasing authority of the regional directors and the AMAC president require approval by a contracting officer within the Division of Procurement and Facilities Management.

In addition to the procurement authorities described above, AMAC, when acting as liquidating agent, is functioning in a recognized distinct legal capacity, effectively as successor in interest to a failed credit union. Actions that AMAC takes in this capacity are not actions taken by NCUA in its normal capacity as a governmental agency. Because the liquidating agents are separate distinct legal entities, NCUA as a governmental agency is not a party to these agreements. NCUA as an executive branch agency is not involved in AMAC contracts in any way, and individuals and contractors retained by AMAC are paid using funds from the liquidation estates.

b. How many individual contractors work for the NCUA right now? How many firms? What are their individual billing rates?

NCUA has 36 individual contractors and 30 firms with 151 contractor personnel working onsite at NCUA's central and regional offices. Of these 187 individuals, 41 perform work for AMAC, which retains individuals from contractor personnel through AMAC's authority acting as liquidating agent.[16] The agency will provide by separate cover a listing of the individuals, firms, contractor personnel, and their associated billing rates. Information is subject to change as contracts are awarded, modified, or performance completed.

c. Please provide this Committee with unredacted copies of all contracts NCUA executed with vendors since 2013 that have a value of $50,000 or more.

NCUA has identified 333 contracts executed with vendors since 2013 that have a value of $50,000 or more. This information will be provided to the Committee in a separate package.

d. Please provide copies of all task orders related to each of these contracts.

This information will be provided in a separate package to the Committee.

NCUA utilizes the Delphi-Oracle Federal Financial System through NCUA's Federal Shared Service Provider (the Department of Transportation Enterprise Services Center) to produce contracts in the form of purchase orders. This system has some limitations when trying to respond to your request. Using Delphi limits NCUA's ability to create unique contract numbers for task and delivery order contracts. Therefore, on its face an NCUA blanket purchase agreement is indistinguishable from a task or delivery order, by contract number.

[16] See 12 C.F.R. 709.4(c).

e. ***Please provide a line-item description of the purpose of each contracted service comprising the $26.2 million figure cited in your budget report.***

We will incorporate this information within the package prepared in response to the previous question. This document will include a description column indicating the purpose for each procurement contract.

Additionally, the attached 11-page report on 2015 contracted services describes in extensive detail the contracted services budget and provides a programmatic breakout by each office. The primary driver for increased costs in 2015 was information technology system upgrade costs for NCUA's information security program—a key priority to protect the sensitive data of the agency, credit unions, and credit union members. The agency is required to comply with the Federal Information System Management Act to enhance its cybersecurity.

18. ***Chairman Matz, in a speech on June 25, 2015, you said that "Because we streamlined the low-income designation process, the number of low-income credit unions has more than doubled. In fact, you may be surprised to learn that low-income credit unions now represent 47 percent of all federal credit unions. Low-income credit unions are exempt from the member business lending cap and restrictions on non-member deposits—that is real regulatory relief."***

    a. ***Your annual report says that in 2009, 14 percent of credit unions had the low-income designation; now, 47 percent have it. On what grounds do you justify a rulemaking exemption that now exempts 1/2 of all credit unions?***

It should be noted that the Federal Credit Union Act authorizes the designation of low-income credit unions. Just to clarify, while 47 percent of all ***federal*** credit unions now have a low-income designation, only 37 percent of all credit unions now have a low-income designation.

In analyzing the trends concerning the number of low-income credit unions, it is important to note the criteria for obtaining a low-income designation have not changed since 2009. What changed is an upgrade to our technological infrastructure that makes it more efficient to determine if a credit union qualifies for the low-income designation.

In the past, a credit union could apply for a low-income designation by providing member address data. NCUA, in turn, would use software to geocode the data and then determine if a majority of the members live in areas meeting the low-income requirements.

In 2012, an upgrade to our technological infrastructure was completed that allowed NCUA to determine, following the completion of each federal credit union examination, whether a given credit union met the requirements for a low-income designation. When examiners upload their reports, NCUA's system receives the member data in a secure and encrypted format. Upon receiving the data, the system follows an algorithm to determine the percentage of members qualifying for low-income designation.

Where credit unions once needed to apply to obtain the low-income designation, the current practice is for NCUA to notify federal credit unions of their eligibility and permit them to "opt in" to accept the low-income designation, if it is consistent with their strategic objectives. This streamlined process has helped credit unions gain regulatory relief in a simple and uncomplicated manner.

b. Please explain how NCUA's actions are not subverting clear Congressional intent and the Federal Credit Union Act.

NCUA's actions support the low-income credit union provisions in the Federal Credit Union Act. The agency's efforts to promote low-income designations help qualifying credit unions facilitate delivery of programs designed to serve low-income members, which is consistent with the intent of the low-income designation programs originated in the late 1970s.

The Federal Credit Union Act authorizes low-income credit unions to accept nonmember deposits from any source and the opportunity to apply for technical assistance grants and low-interest loans from the Community Development Revolving Loan Fund. Since the 1998 enactment of the Credit Union Membership Access Act, the Federal Credit Union Act also exempts qualified credit unions from the member business loan limitation.

19. Chairman Matz, the Credit Share Insurance Fund Parity Act was enacted last Congress to extend insurance protection to lawyer's trust accounts and "other similar escrow accounts." Page 23 of your annual report says that "NCUA will work in 2015 to provide greater clarity and regulatory certainty around broad categories of other escrow accounts that would receive pass-through share insurance coverage."

a. How do you define "escrow account"?

For purposes of our proposed rule, escrow account includes pass-through insurance coverage for lawyers' trust accounts, realtor escrow accounts, and prepaid funeral accounts. However, the NCUA Board invited the public to comment on other similar escrow accounts that might qualify for pass-through insurance coverage.

b. What other broad categories of accounts are NCUA considering as "other similar escrow accounts"?

As I indicated during the open NCUA Board meeting on April 30, 2015, I would support extending pass-through insurance coverage to other similar escrow accounts where licensed professionals serve in a fiduciary capacity and hold funds to benefit their clients. I also specifically asked our Office of General Counsel why the legal research and analysis suggests that prepaid card programs, such as payroll cards, do not legally qualify for pass-through coverage.

NCUA is evaluating the legal issues, as well as all of the comments from the proposed rule, before making a final determination about what constitutes other similar escrow accounts.

c. What key features of an escrow account distinguish it from other products such as prepaid debit cards?

The nature of the relationship between a client and an attorney in a lawyers' trust account can be very different from a prepaid card. Other escrow accounts such as realtor escrow accounts and prepaid funeral accounts likewise serve different purposes and usually have different structures from prepaid card programs.

At the time the NCUA Board proposed the escrow account insurance rule in April 2015, the Office of General Counsel researched the issue and determined that prepaid cards would not legally qualify for pass-through coverage. At the time, NCUA lawyers advised that prepaid cards should not be considered escrow accounts similar to lawyers' trust accounts for share insurance purposes because the characteristics that define a lawyer's relationship with, and the fiduciary duties owed to, the lawyer's clients are typically not present in the prepaid cards. Additionally, there are various categories of prepaid cards with different structures and different characteristics, so it's challenging to consider prepaid cards as though they all fall into a single category.

NCUA's rules already insure certain categories of prepaid cards that meet certain qualifications. So, for example, when a prepaid card is deposited into an insured credit union, if the funds are considered insured shares, and if the card can be correlated to a specific individual and a specific dollar amount, and if that individual is a member of the credit union, then NCUA will certainly provide insurance coverage.

It is also interesting to note that FDIC has viewed the characteristics of many prepaid cards as brokered deposits. NCUA's Office of General Counsel reasoned that the nature of a relationship between a deposit broker and the person who owns the funds is different than the relationship between a lawyer and a client.

However, as part of the proposed rule, the NCUA Board asked specifically for commenters to suggest categories of prepaid cards that may be sufficiently similar to lawyers' trust accounts and therefore should be covered. The preamble of the proposed rule includes key excerpts from Federal Financial Institutions Examination Council documents that provide further explanations of prepaid cards to help commenters focus on this issue.

Staff are now evaluating comments before the NCUA Board makes a final determination on the issue of providing share insurance coverage for prepaid cards. Under certain circumstances, some prepaid card programs may be entitled to pass-through share insurance coverage. I am committed to keeping an open mind on this issue and considering adding such coverage to appropriate accounts in the final rule.

d. When will NCUA's rule be proposed?

NCUA published the proposed rule in the *Federal Register* on May 12, 2015. The comment period closed on July 13, 2015.

Attachments

- Legal Opinion from Paul Hastings, LLP (December 30, 2014)
- Fact Sheet: National Credit Union Administration Budget Process
- Board Action Memorandum on 2015 Budget (November 20, 2014)
- Operating Fund Preliminary and Unaudited Financial Highlights (August 31, 2015)
- NCUA Contracting Report

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December 30, 2014

Board of Directors
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Dear Board Members:

We have acted as counsel to the Board of the National Credit Union Administration (hereinafter, "NCUA Board"), in connection with delivering this opinion letter regarding the legal authority of the National Credit Union Administration (hereinafter, the "NCUA") to implement the proposed rule (79 Fed. Reg. 11184 (Feb. 27, 2014), hereinafter, "Proposed Rule") which would amend Part 702 of the NCUA's regulations regarding prompt corrective action (hereinafter, "PCA") to, among other things, establish a two-tier risk-based net worth (hereinafter, "RBNW")[1] requirement for complex[2] credit unions, a copy of which is provided as Exhibit A.

You have requested our opinion as to the legal authority of the NCUA to establish a separate RBNW requirement for each of "adequately capitalized" and "well capitalized"[3] credit unions that are deemed "complex.".

In connection with this opinion letter, we have examined the Proposed Rule. In addition, we have reviewed the NCUA's statutory authority to implement the Proposed Rule as provided in Section 216 of the Federal Credit Union Act (hereinafter, "FCUA") as added by Section 301 of the Credit Union Membership Access Act (hereinafter, "CUMAA"), as well as the legislative history of the CUMAA, the NCUA's prior implementations and interpretations of Section 216, and other background information provided to us by the NCUA.

This opinion letter is based upon our analysis of the foregoing, pursuant to well established precedent under *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984), which establishes the standard of review for a court reviewing a challenge to a governmental agency's construction of a statute, including in connection with an implementing regulation. Under the so-called *Chevron* standard, in reviewing a federal agency's authority to take certain actions to implement a statute or in connection with a challenge to an agency's efforts to implement a statute, a court must apply a two-prong test. First, the court must determine whether Congress has "directly spoken to the precise question at issue." *Id.* at 842. If Congress's intent is clear in addressing the question at issue, the court must "give effect to the unambiguously expressed intent of Congress." *Id.* at 842-843. If, however, there is ambiguity regarding congressional intent based on the precise meaning of the statutory language, then the court must

[1] We understand that the NCUA has proposed to revise the term "risk-based net worth" to "risk-based capital" to "better describe the equity and assets the requirement would measure" and because "risk-based capital" is the term "more commonly used in the financial services industry." *See* 79 Fed. Reg. at 11185, 11191. However, this opinion letter uses the term "risk-based net worth" and the abbreviation "RBNW" consistent with the NCUA's current rule and the applicable statutes so as to avoid confusion.

[2] Section 216(d) of the Federal Credit Union Act requires the NCUA to develop a RBNW requirement for "complex" credit unions, "as defined by the Board based on the portfolios of assets and liabilities of credit unions." Thus, the "risk-based net worth requirement" at issue can only apply to "complex" credit unions. The NCUA currently defines "complex" credit unions as a credit union that meets both of the following requirements: (1) Minimum assets size. Its quarter-end total assets exceed fifty million dollars ($50,000,000); and (2) Minimum RBNW calculation. Its risk-based net worth requirement as calculated under the standard calculation [12 C.F.R. § 702.106] exceeds six percent (6%). *See* 12 C.F.R. § 702.103.

[3] "Adequately capitalized" and "well capitalized" are defined terms pursuant to Section 216(c) of the FCUA, as defined *infra* page 2-3.

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determine whether the agency's position is based on a permissible construction of the statute. *See id.* at 843. In this regard, an agency's interpretation will generally be deemed permissible and "given controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844.

With respect to this opinion letter, we note that the question raised herein ordinarily would be determined only through a litigated proceeding, and that the outcome of any proceeding before a United States court having jurisdiction over the NCUA, including, but not limited to, any federal district court or appellate court, cannot be predicted with certainty and depends upon the legal arguments, facts and circumstances as they would be presented, admitted and developed in such proceeding.[4]

1. RELEVANT FACTS, ASSUMPTIONS AND LIMITATIONS

a. General Assumptions

As to matters of fact, we have examined and relied exclusively, without independent investigation, upon the statements, and representations of the NCUA Board, its officials and representatives. We have assumed that the Proposed Rule's two-tier RBNW requirement is in substantially the form attached hereto as Exhibit A, that its issuance complied with the NCUA's rulemaking and public comment procedure requirements and that the NCUA will timely perform and satisfy in all respects all of its obligations with respect to implementing a new federal regulation. This opinion letter is based on the assumption that the facts set forth herein and which we have assumed, without investigation, to be true and correct, are, and except as set forth herein, will continue to be, accurate.

We express no opinion as to the law of any jurisdiction other than that of the federal courts. Furthermore, this opinion letter is being furnished to you solely for your benefit in connection with the implementation of the Proposed Rule and is not to be used, circulated, quoted, relied upon or otherwise referred to for any other purpose or by any other person without our prior express written consent, except as otherwise provided herein.

b. Summary of the Proposed Two-Tier RBNW Requirement

Currently, "well capitalized" and "adequately capitalized" credit unions that are deemed "complex" are required to meet a RBNW requirement.[5] Under the current PCA system implemented by the NCUA, a credit union's RBNW requirement is calculated based on each credit union's aggregate risk-weighted amounts of certain types of assets. *See* 12 C.F.R. § 702.106. Thus, an individual credit union's RBNW requirement is unique to the institution and remains constant for the institution regardless of whether the institution seeks to qualify as an "adequately capitalized" or "well capitalized" credit union. *See* 12 C.F.R. Part 702.

Under the Proposed Rule, the NCUA proposes a separate RBNW requirement for each of the "well capitalized" and "adequately capitalized" categories. As explained by the NCUA, "Section 216(c) of the FCUA requires that a credit union that meets the definition of "complex,"[6] and whose net worth ratio initially places it in either of the "adequately capitalized" or "well capitalized" net worth categories, also must satisfy a separate RBNW requirement. Under this separate RBNW requirement, the complex credit union must meet or exceed the minimum RBNW ratio corresponding to its net worth category

[4] 12 U.S.C. § 1789(a)(2) grants U.S. district courts original jurisdiction over suits brought against the NCUA.

[5] *See* 12 U.S.C. § 1790d(c) & (d); 12 C.F.R. § 702.102.

[6] *See supra* n. 2.

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("adequately capitalized" or "well capitalized") in order to remain classified in that category." Proposed Rule, 79 Fed. Reg. at 11186.

With respect to the "well capitalized" and "adequately capitalized" categories, Section 216(c) provides:

> (A) WELL CAPITALIZED – An insured credit union is "well capitalized" if – (i) it has a net worth ratio of not less than 7 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d).
>
> (B) ADEQUATELY CAPITALIZED – An insured credit union is "adequately capitalized" if – (i) it has a net worth ratio of not less than 6 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d).

Section 216(d) sets forth the RBNW requirement for complex credit unions as follows:

> (1) IN GENERAL – The regulations required under subsection (b)(1) shall include a risk-based net worth requirement for insured credit unions that are complex as defined by the Board based on the portfolios of assets and liabilities of credit unions.
>
> (2) STANDARD – The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.

Notably, Section 216(b) of the FCUA requires the NCUA Board to "by regulation, prescribe a system of prompt corrective action for insured credit unions that is – (i) consistent with this section [216 – Prompt Corrective Action]; and (ii) comparable to" section 38 of the Federal Deposit Insurance Act. In this regard, the legislative history provides that "comparable" means "parallel in substance (though not necessarily identical in detail) and equivalent in rigor." *See* S. Rep. No. 193, 105th Cong. 2d Sess. 13, p. 12.

Finally, as noted by NCUA in its July 2000 implementation of 12 C.F.R. Part 702 with respect to the purpose and rationale for the RBNW requirement specific to complex credit unions:

> CUMAA requires NCUA to develop a definition of a "complex" credit union based on the risk level of a credit union's portfolio of assets and liabilities, [12 U.S.C.] § 1790d(d)(1), and to formulate a [RBNW] requirement to apply to credit unions meeting that definition. The RBNW requirement must "take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized [6 percent] may not provide adequate protection." [12 U.S.C.] § 1790d(d)(2). NCUA was encouraged to, "for example, consider whether the 6 percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks. The design of the [RBNW] requirement should reflect a reasoned judgment about the actual risks involved." S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).
>
> These specifications reflect the Department of the Treasury's recommendation to Congress to require NCUA to develop a supplemental RBNW requirement "for larger, more complex credit unions * * * to take account of risks * * * that may exist only for a small subset of credit unions." U.S. Dept. of Treasury, Credit Unions (1997) at 71.

65 Fed. Reg. 44950, 44951 (July 20, 2000).

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2. APPLICABLE LAW – *Chevron* Standard

Courts generally review challenges to a federal agency's construction of a statute that the agency administers under the two-pronged *Chevron* standard.[7] As the U.S. Supreme Court noted in *Chevron*, "[w]hen a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue." *Chevron*, 467 U.S. at 842. According to the Court, under this threshold question, "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842-842 (emphasis added). If, however, "Congress has not directly addressed the precise question at issue, . . . the question . . . is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843. In this regard, as noted in *Chevron*, when a statute is ambiguous with respect to a specific issue, courts must defer to a federal agency's construction of a statute, provided the federal agency's construction is permissible and not "arbitrary, capricious, or manifestly contrary to the statute." *See id.* at 842-843.

Question one of *Chevron* acknowledges the inherent challenge in assigning and determining congressional intent in connection with a statute, particularly in applying the specific laws an agency oversees and administers. In addressing this issue, the Court noted, "[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress." *Id.* The Court further noted it "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations has been consistently followed by [the] Court whenever [a] decision as to the meaning or reach of a statute has involved reconciling conflicting policies, and a full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations." *Id., referencing National Broadcasting Co. v. United States*, 319 U.S. 190; *Labor Board v. Hearst Publications, Inc.*, 322 U.S. 111; *Republic Aviation Corp. v. Labor Board*, 324 U.S. 793; *Securities & Exchange Comm'n v. Chenery Corp.*, 332 U.S. 194; *Labor Board v. Seven-Up Bottling Co.*, 344 U.S. 344. In the Court's view, if an agency's determination "represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, [a court] should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned." *Id.* at 844, *citing United States v. Shimer*, 367 U.S. 374, 383 (1961).

Thus, upon reaching question two of *Chevron*, a court must determine whether the NCUA's construction of Section 216 is a permissible construction. *See Id.* at 843. *Chevron* provides that where Congress has explicitly or implicitly delegated authority to an agency to make rules, the agency's regulations will be permissible and given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844. Courts generally treat the "arbitrary" and "capricious" analysis as a single test when reviewing agency interpretations. *See, e.g., Nat'l Ass'n of Home Builders v. Defenders of Wildlife*,

[7] *See City of Arlington v. FCC*, 133 S. Ct. 1863, 1871 (U.S. 2013); *American Bankers Ass'n v. NCUA*, 93 F. Supp. 2d 35, 2000 U.S. Dist. LEXIS 5209 (D.D.C. 2000) (finding that the NCUA's implementation of rules regarding the formation of multiple common-bond credit unions was a permissible interpretation of the CUMAA under the *Chevron* standard). *See, e.g., United States v. Eurodif S. A.*, 555 U.S. 305 (2009) (applying the *Chevron* test to the Commerce Department's interpretation of its authority to seek antidumping duties and holding that the agency's interpretation was valid); *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 974 (2005) (reviewing an FCC ruling under the Telecommunications Act of 1996 pursuant to a *Chevron* analysis); *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985) (applying *Chevron* to the Army Corps of Engineers' construction of its authority under the Clean Water Act).

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551 U.S. 644 (2007); *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Citizens to Pres. Overton Park, Inc., v. Volpe*, 401 U.S. 402 (1971). A court applying the arbitrary and capricious test must determine "whether there has been a clear error of judgment" by the agency. *See Citizens to Pres. Overton Park*, 401 U.S. at 416; *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 416. Under the arbitrary and capricious test, a court will consider whether the agency based its statutory interpretation on a "consideration of all of the relevant factors" and demonstrated a "rational connection between facts and judgment." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 31. A court would likely deem an agency's interpretation "arbitrary and capricious" if the agency "relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that could not be ascribed to a difference in view or the product of agency expertise." *Id.* at 43; *Nat'l Ass'n of Home Builders*, 551 U.S. at 645.

Notably, even if other potential interpretations exist, *Chevron* provides that "[t]he court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding." *Chevron*, 467 U.S. at 843.

3. LEGAL DISCUSSION – NCUA's Legal Authority

In applying the *Chevron* standard to a determination of whether the NCUA has the legal authority under Section 216 of the FCUA to implement the two-tier RBNW requirement set forth in the Proposed Rule, a court would first need to determine whether Congress has "directly spoken to the precise question at issue." *Id.* at 842. If the court finds in the affirmative, then the court would need to determine whether the NCUA's Proposed Rule had given effect to the "unambiguously expressed intent of Congress." *Id.* at 842-843.

If, however, the court finds that Section 216 of the FCUA is silent or ambiguous with respect to the permissibility of a two-tier RBNW requirement, the court must then determine whether the NCUA's construction of Section 216 is a permissible construction. *Id.* at 843. *Chevron* specifies that where Congress has explicitly or implicitly delegated authority to an agency to make rules, the agency's regulations will be given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844.

This opinion letter sets forth our view as to what a court applying the *Chevron* standard would conclude upon review of the NCUA's legal authority to establish a two-tier RBNW requirement, as set forth in the Proposed Rule, pursuant to the FCUA. We note that this standard requires a court to give considerable deference to the NCUA where ambiguity exists within Section 216 of the FCUA.

a. Chevron Question One – Has Congress Directly Spoken to the Precise Question at Issue?

As discussed above, Section 216(d) mandates the NCUA Board to establish "a risk-based net worth requirement for insured credit unions that are complex" and that the NCUA Board "shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." Under the basic principles of statutory construction, one must review the plain language of the statute; however, "the meaning of statutory language, plain or not, depends on context . . . It is a longstanding principle of statutory construction that 'each part or section' of a statute 'should be construed in connection with every other part or section so as to produce a harmonious whole.'" *See* 2A Norman J. Singer, *Sutherland Statutory Construction* §§ 45:2, 46.05 (5th ed. 1992) (hereinafter, "*Sutherland*"). If the statute's language is ambiguous, the interpretation should be guided by the statute's legislative history.

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See Sutherland § 45.01. After careful review and deliberation, we find that the language of Section 216(d) is, at best, ambiguous with respect to the statutory authority of the NCUA to implement a two-tier RBNW requirement for complex credit unions, as the language can be interpreted in multiple ways, as discussed below.[8]

(i) **Section 216(d)(2)'s Reference to "Adequately Capitalized" and "Adequate Protection"**

Section 216(d)(2) highlights Congress's intent for the NCUA to consider certain types of risks when designing the RBNW requirement applicable to complex credit unions. Section 216(d)(2) requires the RBNW requirement to "take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." We view Section 216(d)(2)'s reference to the "adequately capitalized" PCA category as a baseline reference that is intended to guide the NCUA in determining what types of material risks it must consider. That is, the NCUA must consider the specific types of material risks that would cause a complex credit union that is at least adequately capitalized to have inadequate protection. In other words, the NCUA must identify the "material risks" that would cause a credit union to fall from an adequately capitalized position into an undercapitalized position.

The plain language of Section 216(d)(2) does not expressly restrict the NCUA from imposing a higher RBNW requirement for "well capitalized" versus "adequately capitalized" credit unions for the supervisory purpose of building in additional risk management controls before a credit union becomes undercapitalized. Moreover, nor does the statutory language unambiguously mandate a single, uniform RBNW requirement applicable to "well capitalized" and "adequately capitalized" credit unions. In our view, the only clear restriction imposed on the NCUA as a result of the language in Section 216(d)(2) is that the RBNW requirement that is to be "designed"[9] by the NCUA must take account of certain kinds of "material risks" contemplated by Congress. In this regard, and in our opinion, the language of Section 216(d)(2) does not prevent NCUA from imposing higher requirements on "well capitalized" credit unions to provide greater protection against these risks.

Thus, a reasonable interpretation of Section 216(d)(2) is that the NCUA is being asked to identify material risks that could cause a credit union to become undercapitalized, and to design a RBNW requirement that protects against those material risks. Such a requirement could reasonably impose different degrees of protection for "well capitalized" and "adequately capitalized" credit unions so that well capitalized credit unions are further insulated, and appropriately, *more* protected than adequately capitalized credit unions against the material risks that could cause each of such credit unions to become undercapitalized.

(ii) **Section 216(d)'s Use of "Requirement" in the Singular Form**

Section 216(d)'s reference to a RBNW "requirement" in its singular form is, at most, ambiguous and cannot be viewed as a precise statement of specific congressional intent for several reasons.

[8] Further, given that the NCUA has exercised its general rulemaking authority to implement a two-tier risk-based capital structure in another context, i.e., for corporate credit unions, it appears there is a basis for the NCUA to proceed in this manner for complex credit unions. *See generally* 75 Fed. Reg. 64786 (October 20, 2010). In this regard, we view the more explicit language of Section 216(d) setting forth the standard for a RBNW requirement for complex credit unions as a logical extension of the general authority the NCUA has already previously exercised.

[9] We note that Section 216(d)(2) requires the NCUA to "design" the RBNW requirement. This language suggests that Congress intended to provide the NCUA significant discretion and flexibility, in contrast to other words that Congress could have used, such as "implement."

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First, Section 216(d)'s reference to "requirement" in its singular form logically makes sense when read in conjunction with the language in Section 216(c), which sets forth the five PCA categories, including well capitalized and adequately capitalized. As specified, for each of these latter two categories:

> (A) WELL CAPITALIZED – An insured credit union is "well capitalized" if – (i) it has a net worth ratio of not less than 7 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d).
>
> (B) ADEQUATELY CAPITALIZED – An insured credit union is "adequately capitalized" if – (i) it has a net worth ratio of not less than 6 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d). (emphasis added).

Specifically, it is appropriate that there would be only one RBNW requirement that is applicable at any one time to each PCA category. Section 216(c), the section defining the "well capitalized" and "adequately capitalized" categories, does not unequivocally provide that the same RBNW requirement must apply uniformly to both well capitalized and adequately capitalized credit unions. That is, the definitions for both "well capitalized" and "adequately capitalized" require the credit union to meet "any applicable risk-based net worth requirement under subsection (d)." The legislative history of the CUMAA with respect to Section 216 supports this view and provides that "in order to be well capitalized or adequately capitalized, a complex credit union must meet any applicable risk-based net worth requirement prescribed in this section." S. Rep. No. 193, 105th Cong. 2d Sess. 13, p. 13 (emphasis added).

A reasonable interpretation of the "any applicable risk-based net worth requirement" language includes the interpretation that Congress intended to allow the NCUA to determine what RBNW requirement would be "applicable" in each case for well capitalized and adequately capitalized credit unions. We do not view the language as evidencing congressional intent to preclude the NCUA from implementing different RBNW requirements for different capital categories. Section 216(c)'s reference to "any applicable" requirement supports the view that Congress did not intend to limit the NCUA's authority to implement more than one RBNW requirement for different capital categories. The fact that the legislative history makes reference to both the well capitalized and adequately capitalized categories at the same time and indicates that credit unions in these categories must comply with "any applicable [RBNW] requirement" provides support for why the reference to "requirement" in its singular form is ambiguous in terms of whether more than one requirement was intended. Had Congress intended for only one RBNW requirement to apply in all cases for all complex credit unions in different capital categories, rather than referring to "any applicable" requirement in Section 216(c), Congress could have specifically indicated its intent for "the" or "the same" rather than "any applicable" risk-based net worth requirement for both the adequately capitalized and well capitalized categories. Accordingly, as written, Section 216(d) does not clearly and unambiguously prohibit the NCUA from establishing a two-tier rather than single-tier RBNW requirement.

Secondly, Congress's use of the term "requirement" in its singular form in Section 216(d) should not be viewed as determinative in terms of whether Congress clearly intended for the NCUA to have the authority only to implement a single RBNW requirement. The reference to "requirement" does not directly address the question of whether there may be multiple sub-requirements or different sub-requirements for well capitalized and adequately capitalized credit unions. Notably, the PCA statute for banks also uses the term risk-based capital ("RBC")[10] "requirement" in the singular form; however, banks are subject to

[10] As noted in footnote 1, the NCUA views the term "risk-based capital" as congruous with "risk-based net worth," and has proposed to adopt the term "risk-based capital" in place of "risk-based net worth." *See* 79 Fed. Reg. at 11185, 11191.

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multiple sub-requirements under the RBC requirement, i.e., a common equity Tier 1 RBC requirement, a Tier 1 RBC requirement, and a total RBC requirement, that are different for well capitalized banks versus adequately capitalized banks. *See, e.g.*, 78 Fed. Reg. 62018 (Oct. 11, 2013); 12 U.S.C. 1831o(c)(1)(A). In reviewing Congress's and the federal banking agencies' use of the term "requirement" in its singular form under the current PCA system for banks, Section 216(d)'s similar use of the term "requirement" in its singular form should also not preclude such a requirement from having multiple subparts that are applicable to different PCA categories. Thus, in our opinion, the use of the term "requirement" in its singular form should not be dispositive as to congressional intent.

We also note that even when the NCUA sought congressional authority in April 2007 to change the statutory language in the FCUA to expressly mandate the NCUA to implement a two-tiered RBNW requirement, the NCUA did not seek to change the word "requirement" to "requirements." *See* NCUA White Paper for "Prompt Corrective Action Reform Proposal," p. 10 (April 2007). This further supports our interpretation that the use of "requirement" in the singular form is reasonable and does not expressly and unambiguously demonstrate Congress's intent that only a single-tier RBNW requirement may be established for adequately capitalized and well capitalized credit unions. As such, the reference to "requirement" is at most ambiguous.

(iii) <u>Section 216(c)(1)(C)'s Reference to "Any Applicable Risk-Based Net Worth Requirement under Subsection(d)" for Undercapitalized Credit Unions</u>

Unlike the definitions of "well capitalized" and "adequately capitalized" set forth in Section 216(c)(1)(A) and (B), respectively, which require a credit union to meet both a net worth ratio requirement <u>and</u> a RBNW requirement, the definition for the "undercapitalized" PCA category imposes a disjunctive test – i.e., a credit union is deemed to be "undercapitalized" if "(i) it has a net worth ratio of less than 6 percent; <u>or</u> (ii) it fails to meet any applicable risk-based net worth requirement under subsection (d)." *See* Section 216(c)(1)(C) (emphasis added).

Some may interpret this distinction as supporting the view that Congress intended for NCUA to establish only a single RBNW requirement that is the "applicable" requirement for all complex credit unions, including for purposes of determining whether a credit union is undercapitalized. In our opinion, however, there is a more reasonable interpretation and application of the disjunctive test used in Section 216(c)(1)(C) for undercapitalized credit unions (as opposed to the conjunctive test used for well capitalized and adequately capitalized credit unions) with respect to the "any applicable [RBNW] requirement" language. This interpretation is that Congress specifically granted the NCUA the authority and flexibility to determine what RBNW requirement would be "applicable" in each case for: (i) well capitalized credit unions, pursuant to Section 216(c)(1)(A); (ii) adequately capitalized credit unions, pursuant to Section 216(c)(1)(B); and (iii) undercapitalized credit unions, pursuant to Section 216(c)(1)(C). This regulatory flexibility provided by the statutory language on its face does not restrict the NCUA from designating the RBNW requirement "applicable" to adequately capitalized complex credit unions as also being the requirement "applicable" to undercapitalized complex credit unions. Rather, it allows the agency to designate a separate higher RBNW requirement specifically "applicable" only to well capitalized complex credit unions, in each case due to the "any applicable . . . requirement" language in each provision. As such, the broad reference to "any applicable . . . requirement" in each of Section 216(c)(1)(A), (B), and (C) supports the view that the NCUA possesses the requisite legal authority and regulatory discretion to impose more than one RBNW requirement for credit unions falling within different PCA categories.

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(iv) **Section 216(b)'s Mandate for a PCA System "Consistent" with the Statute but "Comparable" to Section 38 of the Federal Deposit Insurance Act**

An equally compelling consideration is that Section 216(b) mandates that the NCUA develop a PCA system for credit unions that is "consistent" with Section 216 and "comparable" to the PCA system for banks. The legislative history of the CUMAA explains that "consistency" refers to the "specific restrictions and requirements of new section 216" and "'comparable' here means parallel in substance (though not necessarily identical in detail) and equivalent in rigor." S. Rep. No. 105-193, p. 12 (1998) (emphasis added). As discussed herein, it is our view that the express language of Section 216 taken as a whole provides the NCUA with the necessary interpretive flexibility to implement a two-tier RBNW system that does not violate any specific restrictions and/or requirements of Section 216, as we have not identified any express statutory restriction or requirement imposed on the NCUA to implement a single-tier RBNW system. Thus, we believe the NCUA's interpretation and implementation of a two-tier RBNW system is consistent with the requirements of Section 216.

Moreover, in our opinion, the mandate for the NCUA to develop a PCA system that is "equivalent in rigor" with the PCA system for banks further supports an interpretation of Section 216(d) that allows the NCUA the flexibility to impose a two-tier RBNW system. It is not only logical but, arguably, imperative that the credit union PCA system reflect different gradations in protection for well capitalized and adequately capitalized credit unions, especially given Congress's clear intent for the credit union PCA system to be "equivalent in rigor" with the PCA system for banks. *See* S. Rep. No. 105-193, p. 12 (1998). Bolstering this view is that credit unions, unlike banks, do not have the ability to resort to capital raising activities in the market to increase and/or maintain capital. Instead, credit unions are largely restricted to preserving and protecting their capital through their own retained earnings. From a safety and soundness standpoint, a prudent and reasonable expectation from both a supervisory and regulatory perspective is for the NCUA to have in place a PCA system that takes account of differences between banks and credit unions – including weaknesses that credit unions have relative to banks – in a manner that allows the NCUA to act to maintain comparable levels of capital protection for well capitalized credit unions compared to well capitalized banks.

With respect to the particular vulnerabilities of credit unions relative to capital, imposing a two-tiered RBNW system appears to be the type of equivalence in rigor required to address the "lessons learned" by the NCUA in dealing with "several hundred millions of dollars in losses . . . of [failed] credit unions holding inadequate levels of capital relative to [their] levels of [portfolio] risk" that previously ignored warnings from NCUA officials "to hold higher levels of capital to offset the risks in their portfolios." 79 Fed. Reg. 11186. It is also reasonable that more stringent credit union capital rules should follow on the heels of more stringent bank capital and PCA rules finalized in July 2013, which are due to become effective in January 2015. Accordingly, an interpretation of Section 216(d) that is consistent with the policy objectives set forth by Congress in Section 216(b) for the credit union PCA system to be consistent with the statute but "equivalent in rigor" to that of banks supports a two-tiered RBNW requirement comparable to that imposed on banks.

(v) **Conclusion for Question One under *Chevron***

While other potential interpretations and viewpoints of Section 216(d) are supportable, the existence of alternative interpretations does not preclude a court finding in favor of the NCUA's two-tier RBNW requirement under the Proposed Rule pursuant to the *Chevron* standard. Under *Chevron*, when statutory language is ambiguous, courts must defer to an agency's interpretation of the statute, provided the interpretation is permissible, i.e., not arbitrary, capricious, or manifestly contrary to the statute. As discussed above, the reference to "adequately capitalized" and use of the term "requirement" in the singular form in Section 216(d) does not demonstrate a "clear and unambiguous" congressional intent

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that a single-tier RBNW requirement must be applied uniformly to well capitalized and adequately capitalized credit unions. Moreover, the simple fact that the language in Section 216(d) may yield multiple interpretations clearly demonstrates the ambiguity of the statutory language. As such, it is our view that, in a case properly presented and argued, a court would likely conclude that Section 216 of the FCUA is ambiguous with respect to the permissibility of the NCUA's implementation of a two-tier RBNW requirement, as described in the Proposed Rule. The court would then be required to turn to the second question under *Chevron*, which is whether the NCUA's interpretation of Section 216 of the FCUA, as set forth in the Proposed Rule, is a permissible construction of the statutory language.

b. Chevron Question Two – Given the Determination in Question One that Section 216(d) Is at Most Ambiguous, Is the NCUA's Interpretation Based on a "Permissible Construction" of the Statute?

In applying *Chevron*, a court must determine whether the NCUA's construction of Section 216 of the FCUA is a permissible construction. *See Chevron*, 467 U.S. at 843. *Chevron* provides that where Congress has explicitly or implicitly delegated authority to an administrative agency to make rules, the agency's regulations will be permissible and given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844. Through the FCUA, Congress has explicitly delegated authority to the NCUA under Section 216(b) of the FCUA to promulgate rules to "prescribe a system of prompt corrective action for insured credit unions" that is (i) consistent with Section 216 of the FCUA and (ii) "comparable" to the PCA provisions of the Federal Deposit Insurance Act for banks. 12 U.S.C. § 1790d(b)(1)(A). Thus, the NCUA's interpretation of Section 216(d) authorizing the NCUA to establish a two-tier RBNW requirement, as set forth in the Proposed Rule, would generally be viewed by a court as permissible and be given controlling weight unless it is "arbitrary, capricious, or manifestly contrary to the statute." *Id.* at 844. Courts generally treat the "arbitrary" and "capricious" analysis as a single test when reviewing agency interpretations. *See, e.g., Nat'l Ass'n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644 (2007); *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Citizens to Pres. Overton Park, Inc., v. Volpe*, 401 U.S. 402 (1971). As discussed below, it is our view that the NCUA's implementation of a two-tier RBNW requirement should withstand both a court challenge that asserts the NCUA's interpretation is "arbitrary and capricious," as well as a challenge asserting that the NCUA's position is "manifestly contrary to the statute."

(i) Arbitrary and Capricious Standard

Although the NCUA's interpretation set forth in the Proposed Rule constitutes a reasonable construction of Section 216(d) as discussed above, we note that questions could arise with respect to the potential arbitrariness and capriciousness of the NCUA's current interpretation under the Proposed Rule, in light of potentially inconsistent positions previously taken by the NCUA.

In regard to whether the NCUA's interpretation may withstand *Chevron* scrutiny and, in particular, whether the interpretation is arbitrary and capricious, the NCUA could encounter challenges with respect to its prior interpretation and actions in implementing Section 216. For example, the NCUA's prior regulations implemented the RBNW requirement in Section 216(d) by establishing a system with a single-tier structure, or alternatively, as a system that imposes multiple RBNW requirements where each complex credit union is subject to its own unique RBNW requirement. *See* 12 C.F.R. Part 702. The NCUA has held this position in the agency's regulations since 2000. *See* 65 Fed. Reg. 44950 (July 20, 2000). In its original proposed rule in 2000, the NCUA stated the "NCUA Board has determined that a 6 percent net worth ratio is sufficient to protect against an average level of risk, but that a measure of additional net worth is needed to compensate for risks which are above average. For this reason, the final rule limits the scope of its RBNW requirement to credit unions that have an above average level of risk exposure." *Id.* at 44955. Additionally, the U.S. Treasury Department assessed the NCUA's

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implementation of Section 216 in 2001 and found that "[i]n general, the NCUA implemented the RBNW requirements as Congress intended." *See* Treasury Report Required Under Sections 401 and 403 of the CUMAA, *Comparing Credit Unions With Other Depository Institutions*, p. 14 (Jan. 2001). Thus, the NCUA's current two-tier interpretation in the Proposed Rule, viewed in light of its prior interpretation and implementation of a single-tier RBNW requirement, could be viewed as an arbitrary change in position and, as such, may be susceptible to challenge under *Chevron*'s arbitrary and capricious standard.

In our view, however, the NCUA's position is defensible, and there are reasonable arguments that such a challenge can be overcome under *Chevron* if the NCUA bolsters its rationale for and empirical data supporting the change in position to implement an enhanced system of PCA for credit unions. This view is supportable under case law, which provides that a reversal of position by an agency or interpretation "inconsistent with its past practice" is not arbitrary or capricious "if the agency adequately explains the reasons for a reversal of policy." *See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005). In *Nat'l Cable & Telecomms. Ass'n*, the Supreme Court held that under *Chevron* review a change in agency interpretation "is not invalidating, since the whole point of *Chevron* is to leave the discretion provided by the ambiguities of a statute with the implementing agency." 545 U.S. at 981. The Court specified that "[a]n initial agency interpretation is not instantly carved in stone. On the contrary, the agency . . . must consider varying interpretations and the wisdom of its policy on a continuing basis . . . for example, in response to changed factual circumstances, or a change in administrations." *See id.* In *Nat'l Cable & Telecomms Ass'n*, the Supreme Court found the National Cable and Telecommunication Association's reason for changing its position on the applicability of common-carrier treatment to facilities-based carriers as a result of changed market conditions to be adequate justification. *See id.* at 1001. Thus, even if the NCUA's establishment of a two-tier RBNW requirement is deemed to be a change in position, the NCUA's new interpretation would generally not be expected to be deemed arbitrary or capricious, provided the NCUA adequately justifies its new position. Given the change in market conditions over the past 14 years, the recent financial crisis, and changes in the PCA system for banks, it is our view that the NCUA can reasonably justify a transition to a more conservative two-tier RBNW requirement that is intended to better protect against potential risks to credit unions.

(ii) <u>Manifestly Contrary to the Statute Standard</u>

As discussed above in Section 3.a.iv., the NCUA's implementation of a two-tier RBNW requirement appears consistent with the specific restrictions and requirements of Section 216, as we believe that the express language of Section 216, taken as a whole, provides the NCUA with the necessary interpretive flexibility to implement a two-tier RBNW system that does not violate any specific restrictions or requirements of Section 216. Thus, the NCUA's interpretation and proposed implementation of a two-tier RBNW requirement, as set forth in the Proposed Rule, should not be viewed as being manifestly contrary to Section 216, specifically given that Section 216 does not expressly prohibit the establishment of a two-tier RBNW requirement and the NCUA's position is consistent with the policy objectives of Congress set forth in Section 216(b).

(iii) <u>Conclusion for Question Two under *Chevron*</u>

As Congress expressly delegated authority to the NCUA to design a RBNW requirement, the NCUA's proposed two-tier RBNW requirement under the Proposed Rule constitutes a permissible construction of the statute and, as such, should be upheld by a court under the *Chevron* doctrine. By providing sufficient explanation of its reasons for imposing a higher and more conservative RBNW requirement for complex credit unions to be deemed well capitalized, it is our view that the NCUA's implementation of a two-tiered RBNW requirement would withstand a court challenge alleging the agency's approach is arbitrary, capricious, or manifestly contrary to the statutory language of Section 216 of the FCUA.

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4. CONCLUSION

Based on the foregoing facts and a reasoned analysis of *Chevron* and Section 216 of the FCUA, we are of the opinion that, under current principles of applicable law and existing case law, a court of appropriate jurisdiction, in a litigated matter or proceeding, could conclude that the NCUA's statutory authority pursuant to Section 216 of the FCUA permits the NCUA to establish the proposed two-tier RBNW requirement set forth in the Proposed Rule.

In providing this reasoned legal opinion, we express no opinion as to the availability or effect of a preliminary injunction, temporary restraining order or other such temporary relief affording delay pending a determination of the issue on the merits. Furthermore, we express no opinion as to any legal or equitable principles with respect to the NCUA's rulemaking procedural requirements that would have the effect of negating implementation of the Proposed Rule.

The foregoing opinion is expressly subject to there being no material change in the law and there being no additional facts that would materially affect the validity of the assumptions and conclusions set forth herein or upon which this opinion letter is based. The opinion expressed in this opinion letter may be relied upon solely by you, the Board of NCUA, and no one else. In addition, reliance upon this opinion letter in connection with the matters set forth herein is subject to the understanding that this opinion letter is given on the date hereof and our opinion is rendered only with respect to facts described herein and laws, rules and regulations currently in effect. Without our prior express written consent, this opinion letter may not be furnished to, or used or relied upon by any other person or entity, or in any other context, and may not be quoted, in whole or in part, or otherwise referred to, nor filed with or furnished to any governmental agency or other person. This opinion letter is provided solely for the benefit of the NCUA and its Board of Directors in connection with the agency's deliberations on the Proposed Rule. This opinion letter may not be relied upon by the NCUA or its Board for any other purpose, relied upon by any other person or quoted without our prior express written consent.

We note that a court's decision would be based upon its own analysis and interpretation of the facts before it and applicable legal principles. Therefore, our opinion is based on the assumption that in any case in which this question is considered, the question will be competently briefed and argued by the NCUA. Our opinion is reasoned and also presumes that any decision rendered will be based on existing legal precedents on the date hereof, including those discussed above. The foregoing opinion is expressly subject to there being no material change in the FCUA or the precedential status of *Chevron*. Nothing in this opinion letter shall be construed as the rendering of advice with respect to the rulemaking process, strategies employed by counsel, or other factors or circumstances that might affect the outcome of those proceedings.

This opinion letter is not a guaranty as to outcome or results, or as to what any particular court would actually hold or what actions a particular court may take, but a reasoned opinion as to the decision we believe a court could well reach if the issues are properly presented to it and the court followed existing precedent on the date hereof as to legal and equitable principles applicable in challenges to agency statutory construction.

This opinion letter deals only with the specified legal issues expressly addressed herein, and you should not infer any opinion that is not explicitly addressed herein from any matter stated in this opinion letter. The opinions expressed herein are to be governed by the federal law of the United States and shall be construed in accordance with the customary practice of lawyers who regularly give, and lawyers who regularly advise opinion recipients regarding, opinions of the kinds contained herein.

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This opinion letter speaks only as of the date hereof and is not to be deemed to have been reissued by any subsequent delivery of a copy hereof. We expressly disclaim any responsibility to advise you or any other person of any development or circumstance of any kind, including any change in law or fact that may occur after the date of this opinion letter that might affect the opinions expressed in this opinion letter.

Very truly yours,

Paul Hastings LLP

PAUL HASTINGS LLP

EXHIBIT A

NCUA Proposed Rule, 79 Fed. Reg. 11184 (Feb. 27, 2014)

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Part II

National Credit Union Administration

12 CFR Parts 700, 701, 702 et al.
Prompt Corrective Action—Risk-Based Capital; Proposed Rule

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 700, 701, 702, 703, 713, 723, and 747

RIN 3133–AD77

Prompt Corrective Action—Risk-Based Capital

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: The NCUA Board (Board) is proposing to amend NCUA's regulations regarding prompt corrective action (PCA) to restructure the part, and make various revisions, including replacing the agency's current risk-based net worth requirements with new risk-based capital requirements for federally insured "natural person" credit unions. The proposed risk-based capital requirements would be more consistent with NCUA's risk-based capital measure for corporate credit unions and the regulatory risk-based capital measures used by the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, and Office of the Comptroller of Currency (Other Federal Banking Regulatory Agencies). In addition, the proposed revisions would revise the risk-weights for many of NCUA's current asset classifications; require higher minimum levels of capital for federally insured natural person credit unions with concentrations of assets in real estate loans, member business loans (MBLs) or higher levels of delinquent loans; and set forth the process for NCUA to require an individual federally insured natural person credit union to hold higher levels of risk-based capital to address unique supervisory concerns raised by NCUA. The proposed revisions would also eliminate several of NCUA's provisions, including provisions relating to regular reserve accounts, risk-mitigation credits, and alternative risk-weights.

DATES: Comments must be received on or before May 28, 2014.

ADDRESSES: You may submit comments, identified by RIN 3133–AD77, by any of the following methods (Please send comments by one method only):

- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.
- *NCUA Web site: http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx*. Follow the instructions for submitting comments.
- *Email:* Address to *regcomments@ncua.gov*. Include "[Your name]—Comments on Proposed Rule: PCA—Risk-Based Capital" in the email subject line.
- *Fax:* (703) 518–6319. Use the subject line described above for email.
- *Mail:* Address to Gerard Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.
- *Hand Delivery/Courier:* Same as mail address.

You can view all public comments on NCUA's Web site at *http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx* as submitted, except for those we cannot post for technical reasons. NCUA will not edit or remove any identifying or contact information from the public comments submitted. You may inspect paper copies of comments in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518–6546 or send an email to *OGCMail@ncua.gov*.

FOR FURTHER INFORMATION CONTACT: *Technical:* Steven Farrar, Loss/Risk Analyst, Office of Examination and Insurance, at 1775 Duke Street, Alexandria, VA 22314 or telephone: (703) 518–6393, or *Legal:* John H. Brolin, Staff Attorney, Office of General Counsel, at 1775 Duke Street, Alexandria, VA 22314 or telephone: (703) 518–6438.

SUPPLEMENTARY INFORMATION:

I. Summary of the Proposed Rule

The Board is proposing to revise and replace NCUA's current PCA rules for federally insured natural person credit unions.[1] The proposed revisions would include a new method for computing NCUA's risk-based capital measure that is more consistent with the risk-based capital measure for corporate credit unions[2] and the risk-based capital measures used by the Other Federal Banking Regulatory Agencies.[3] In general, the revisions would adjust the risk-weights for many asset classifications to lower the minimum risk-based capital requirement for credit unions with low risk operations. Conversely, the revisions would require higher minimum levels of risk-based capital for credit unions with concentrations of assets in real estate loans, MBLs, or high levels of delinquent loans. In addition, due to the known limitations of any widely applied risk-based measurement system, the proposed rule includes procedures for NCUA to require an individual credit union to hold a higher level of risk-based capital where specific supervisory concerns arise regarding the credit union's condition. Finally, the revisions would eliminate the provisions of current § 702.401(b) relating to transfers to the regular reserve account, current § 702.106 regarding the standard calculation of risk-based net worth requirement, current § 702.107 regarding alternative components for standard calculation, and current § 702.108 regarding risk-mitigation credit.

A. Background

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. NCUA performs this public function by examining and supervising all federal credit unions, participating in the examination and supervision of federally insured state chartered credit unions in coordination with state regulators, and insuring federally insured credit union members' accounts.[4] In its role as administrator of the National Credit Union Share Insurance fund (NCUSIF), NCUA insures and regulates approximately 6,753 federally insured credit unions, holding total assets exceeding $1 trillion and representing approximately 94.6 million members.

In 1998, Congress enacted the Credit Union Membership Access Act (CUMAA).[5] Section 301 of CUMAA added new section 216 to the Federal Credit Union Act (FCUA),[6] which requires the Board to adopt by regulation a system of PCA to restore the net worth of federally insured "natural person" credit unions (credit unions) that become inadequately capitalized. In developing the system, the Board is required to take into account that credit unions do not issue capital stock, must rely on retained earnings to build net worth, and have boards of directors that consist primarily of volunteers. In 2000, the Board implemented the required system of PCA primarily under part 702 of NCUA's regulations.[7]

[1] 12 CFR Part 702.

[2] *See* 12 CFR Part 704.

[3] *See* 78 FR 55339 (Sept. 10, 2013).

[4] Within the nine states that allow privately insured credit unions, approximately 133 state-chartered credit unions are privately insured and are not subject to NCUA regulation or oversight.

[5] Public Law 105–219, 112 Stat. 913 (1998).

[6] 12 U.S.C. 1790d.

[7] 12 CFR Part 702; *see also* 65 FR 8584 (Feb. 18, 2000) *and* 65 FR 44950 (July 20, 2000).

The purpose of section 216 of the FCUA is to "resolve the problems of [federally] insured credit unions at the least possible long-term loss to the [NCUSIF]." [8] To carry out that purpose, Congress set forth a basic structure for PCA in section 216 that consists of three principal components: (1) A framework combining mandatory actions prescribed by statute with discretionary actions developed by NCUA; (2) an alternative system of PCA to be developed by NCUA for credit unions defined as "new"; and (3) a risk-based net worth requirement to apply to credit unions that NCUA defines as "complex." This proposed rule is primarily focused on principal components (1) and (3), although amendments to part 702 of NCUA's regulations relating to principal component (2) are also being proposed.

Section 216(c) of the FCUA requires NCUA to, among other things, use a credit union's net worth ratio to determine its classification among five "net worth categories" set forth in the statute.[9] In general, "net worth" is defined as the retained earnings balance of the credit union,[10] and a credit union's "net worth ratio" is the ratio of its net worth to its total assets.[11] As a credit union's net worth ratio declines, so does its classification among the five net worth categories, thus subjecting it to an expanding range of mandatory and discretionary supervisory actions.[12]

In addition to the net worth ratio component described above, section 216(d) of the FCUA requires NCUA to define the term "complex" credit union "based on the portfolios of assets and liabilities of credit unions." [13] It also requires NCUA to formulate a risk-based net worth (RBNW) requirement to apply to credit unions meeting that definition.[14] The RBNW requirement must "take account of any material risks against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized [(6 percent net worth ratio)] may not provide adequate protection." [15] Congress encouraged NCUA to, "for example, consider whether the 6 percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks. The design of the [RBNW] requirement should reflect a reasoned judgment about the actual risks involved." [16]

Under current § 702.103 of NCUA's regulations, a credit union is defined as "complex" if "[i]ts quarter-end total assets exceed fifty million dollars ($50,000,000); and . . . [i]ts [RBNW] requirement, as calculated under § 702.106, exceeds six percent (6%)." [17] Current § 702.104 of NCUA's regulations defines eight risk portfolios of complex credit union assets, liabilities, or contingent liabilities (Table 1); and current § 702.106 sets forth the specific risk-weightings that are applied to the assets (Table 2).

TABLE 1—CURRENT § 702.104 RISK PORTFOLIOS DEFINED

Risk portfolio	Assets, liabilities, or contingent liabilities
(a) Long-term real estate loans.	Total real estate loans and real estate lines of credit (excluding MBLs) with a maturity (and next rate adjustment period if variable rate) greater than 5 years.
(b) MBLs outstanding	MBLs outstanding.
(c) Investments	As defined by federal regulation or applicable state law.
(d) Low-risk assets	Cash on hand and NCUSIF deposit.
(e) Average-risk assets	100% of total assets minus sum of risk portfolios above.
(f) Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse, except for loans sold to the secondary mortgage market with a recourse period of 1 year or less.
(g) Unused MBL commitments.	Unused commitments for MBLs.
(h) Allowance	Allowance for Loan and Lease Losses limited to equivalent of 1.50% of total loans.

TABLE 2—§ 702.106 STANDARD CALCULATION OF RBNW REQUIREMENT

Risk portfolio	Amount of risk portfolio (as percent of quarter-end total assets) to be multiplied by risk-weighting	Risk-weighting
(a) Long-term real estate loans	0 to 25.00%	.06
	over 25.00%	.14
(b) MBLs outstanding	0 to 15.00%	.06
	>15.00% to 25.00%	.14
	over 25.00%	
(c) Investments	*By weighted-average life:*	
	0 to 1 year	.03
	>1 year to 3 years	.06
	>3 years to 10 years	.12
	>10 years	.20
(d) Low-risk assets	All %	.00
(e) Average-risk assets	All %	.06
(f) Loans sold with recourse	All %	.06
(g) Unused MBL commitments	All %	.06
(h) Allowance	Limited to equivalent of 1.50% of total loans (expressed as a percent of total assets).	(1.00)

A credit union's RBNW requirement is the sum of eight standard components. A standard component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its risk-weighting. A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement.

[8] 12 U.S.C. 1790d(a)(1).

[9] Section 1790d(c).

[10] Section 1790d(o)(2).

[11] Section 1790d(o)(3).

[12] Section 1790d(c)–(g); 12 CFR 702.204(a)–(b).

[13] Section 1790d(d).

[14] *Id.*

[15] Section 1790d(d)(2).

[16] S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).

[17] *See* 12 CFR 702.103 & .104 *and* 12 U.S.C. 1790d(o).

Section 216(c) of the FCUA requires that a credit union that meets the definition of "complex," and whose net worth ratio initially places it in either of the "adequately capitalized" or "well capitalized" net worth categories, also satisfy a separate RBNW requirement. Under this separate RBNW requirement, the credit union must meet or exceed the minimum RBNW ratio corresponding to its net worth category (adequately capitalized or well capitalized) in order to remain classified in that category.[18] A complex credit union that meets the net worth ratio requirement for being adequately capitalized or well capitalized, but that fails to meet the corresponding RBNW requirement for either net worth category, is classified by section 216(c)(1) as "undercapitalized", and is subject to the mandatory and discretionary supervisory actions applicable to that category.[19]

The RBNW requirement for credit unions meeting the definition of "complex" was first applied on the basis of data in the Call Report reflecting activity in the first quarter of 2001.[20] NCUA's RBNW requirement has been largely unchanged since its implementation, with the following limited exceptions:

- Revisions were made in 2003 to amend the RBNW requirements for MBLs.[21]
- Revisions were made in 2008 to incorporate a change in the statutory definition of "net worth."[22]

In addition, the Board amended part 702 in 2011 to expand the definition of "low-risk assets" to include debt instruments on which the payment of principal and interest is unconditionally guaranteed by NCUA,[23] and again in 2013 to exclude credit unions with total assets of $50 million or less from the definition of "complex" credit union.[24]

B. Why is the NCUA Board issuing this rule?

The Board is proposing to change NCUA's general risk-based capital rules for determining the minimum level of required capital to enhance risk sensitivity and address weaknesses in the existing regulatory capital framework for credit unions. Capital and risk go hand-in-hand, and credit union senior management, boards, and regulators are all accountable for ensuring that appropriate capital levels are in place based on the credit union's risk exposure. The proposed rule reflects an effort to establish a risk-weighting system that is more indicative of the potential risks existing within credit unions. The proposed rule is intended to help credit unions better absorb losses and establish a safer, more resilient, and more stable credit union system. The improved resilience will enhance credit unions' ability to function during periods of financial stress and reduce risks to the NCUSIF.

In general, credit unions have high quality capital, with retained earnings being the predominant form of capital. However, in recent years, the NCUSIF did experience several hundred millions of dollars in losses due to failures of individual credit unions holding inadequate levels of capital relative to the levels of risk associated with their assets and operations. Examiners did warn officials at these credit unions that they needed to hold higher levels of capital to offset the risks in their portfolios, but the credit union officials ignored the examiners' recommendations, which were unenforceable. This proposal seeks to incorporate the lessons learned from those failures and better account for risks not addressed by the current rule.

The new risk-based capital requirements being proposed in this rule would apply to all credit unions with over $50 million in total assets. The capital requirements and PCA supervisory actions for "new" credit unions and credit unions with $50 million or less in assets would remain largely unchanged, with a few exceptions discussed in more detail below.

In developing the new risk-based capital requirement for "complex" credit unions, NCUA set forth the following goals for the proposed rule. First, the requirement should address weaknesses in the net worth ratio measure. Second, the requirement should address credit risk, interest rate risk, concentration risk, liquidity risk, operational risk, and market risk. Third, the requirement should enhance the stability of the credit union system. Fourth, the rule should rely primarily on data already collected on the Call Report to minimize additional recordkeeping burdens. Fifth, the requirement should be, given the preceding four goals, as easy as possible to understand and implement.

The proposed rule would replace the RBNW method currently used by credit unions to apply risk-weightings to their assets with a new risk-based capital ratio method that is more commonly applied to depository institutions worldwide. The proposed risk-based capital ratio is the percentage of a credit union's net worth available to cover losses, divided by the credit union's defined risk-weighted asset base. The Board believes the change in methodology would improve the comparison of assets and risk-adjusted capital levels across financial institutions. Use of a consistent framework for assigning risk-weights would promote improved understanding between all types of federally insured financial institutions.

This proposed rule would provide a common measure of asset risk and ensure that credit unions retain levels of capital that are commensurate with their level of risk. The proposal would also help NCUA identify, and credit unions to avoid, inadequately capitalized concentrations of asset classes that can lead to a credit union's failure. Further, under the proposed rule, credit unions would be better able to implement strategic plans based on their unique member service objectives and the corresponding risk by holding the appropriate level of capital.

The measure for a credit union's "net worth ratio," which is defined in section 216(o)(3) of the FCUA, is a generalized measure of a credit union's net worth.[25] The net worth ratio of a credit union includes balance sheet accounts in the numerator that may have little or no value in the event of liquidation and excludes off-balance sheet exposures from the numerator. Recognizing these limitations of the net worth measure, Congress directed the Board in section 216(d)(2) of the FCUA to develop a RBNW requirement that "take[s] account of any material risks against which the net worth ratio . . . may not provide adequate protection."[26] The proposed risk-based capital measure includes only capital available to cover losses and takes into

[18] The RBNW requirement also indirectly impacts credit unions in the "undercapitalized" and lower net worth categories, which are required to operate under an approved net worth restoration plan. The plan must provide the means and a timetable to reach the "adequately capitalized" category. Section 1790d(f)(5); *12 CFR 702.206*(c). However, for "complex" credit unions in the "undercapitalized" or lower net worth categories, the minimum net worth ratio "gate" to that category will be 6 percent or the credit union's RBNW requirement, if higher than 6 percent. In that event, a complex credit union's net worth restoration plan will have to prescribe the steps a credit union will take to reach a higher net worth ratio "gate" to that category. *See 12 CFR 702.206*(c)(1)(i)(A). Section 1790d(c)(1)(A)(ii) and (c)(1)(B)(ii).

[19] 12 U.S.C. 1790d(c)(1)(c)(ii).

[20] 65 FR 44950 (July 20, 2000).

[21] 68 FR 56537 (Oct. 1, 2003).

[22] 73 FR 72688 (Dec. 1, 2008).

[23] 76 FR 16234 (Mar. 23, 2011).

[24] 78 FR 4033 (Jan. 18, 2013).

[25] 12 U.S.C. 1790d(o)(3) ("The term 'net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union.").

[26] 12 U.S.C. 1790d(d)(2).

consideration the credit union's off-balance sheet items and other risk factors.

Operating a credit union involves taking and managing a variety of risks, with the major types of risks identified and defined in Table 3 below.

TABLE 3—MAJOR TYPES OF RISKS IDENTIFIED IN CREDIT UNION BUSINESS [27]

Risk	Definition
Credit risk	The potential for loss resulting from the failure of a borrower or counterparty to perform on an obligation.
Compliance risk	The potential for loss arising from violations of laws or regulations or nonconformance with internal policies or ethical standards.
Concentration risk	The risk arising from excessive exposure to certain markets, industries, or groups.
Interest rate risk	A type of market risk that involves the potential for loss due to adverse movements in interest rates.
Liquidity risk	The risk that a credit union will be unable to meet its obligations when they become due, because of an inability to liquidate assets or obtain adequate funding.
Market risk	The potential for loss resulting from movements in market prices, including interest rates, commodity prices, stock prices, and foreign exchange rates.
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.
Reputation risk	The potential for loss arising from negative publicity regarding an institution's business practices.
Strategic risk	The potential for loss arising from adverse business decisions or improper implementation of decisions.

The current RBNW measure focuses primarily on interest rate risk. However, the proposed risk-based capital ratio measure would focus more broadly on the various types of risks to credit unions by addressing additional risk factors and assigning specific risk-weights to:

- Delinquent loans,
- Concentrations of MBLs and real estate-secured loans,
- Equity investments, and
- Additional off-balance sheet exposures.

Rigorous and disciplined risk-based (risk-based capital ratio measure) and non-risk-based (net worth ratio measure) capital requirements working well together can enhance the ability of a credit union to cope with capital impairment during economic downturns. Moreover, an adequate capital buffer can cushion performance deterioration during times of stress, thereby promoting safety and soundness of the credit union system.

The proposed risk-based capital ratio measure primarily uses existing information contained in the Call Report. As compared to the current RBNW measure, the proposed risk-based capital ratio measure would include a greater number of exposure categories for purposes of calculating total risk-weighted assets. Thus, some additional data would need to be collected on the Call Report. This additional data would not, however, represent a material increase to the burden of completing the Call Report. The proposed extended effective date of the final rule would provide ample time for credit unions to adjust their systems to account for the additional data items that would be required in the Call Report.

Through this notice, NCUA invites public comment on all aspects of the proposed rule. Commenters are urged to recognize, however, that NCUA lacks discretion to deviate from the statutory requirements of section 216 of the FCUA.[28] To facilitate consideration of public comments on the proposed rule, the Board urges commenters to organize their comment letters on a section-by-section basis that corresponds with the proposed sections of the rule, and to include any general comments in its own section of the letter.

C. Impact of the Proposed Regulation

The proposed rule would make changes to the minimum regulatory capital requirement for credit unions that would be more reflective of risk, including additional subcategories of assets for risk measurement and additional concentration levels. This shift in emphasis would encourage credit unions to more actively manage risk in relation to the minimum required capital levels. As proposed, the rule would modify the current calculation method for computing RBNW to be more consistent with the risk-based capital measures used by the Other Federal Banking Regulatory Agencies. The proposed change in the calculation would allow setting specific risk-based capital ratio requirements for the top three capital classifications.

NCUA's analysis of 2013 Call Report data indicates that the overwhelming majority of credit unions with over $50 million in assets already have sufficient capital to comply with the proposed risk-based capital rules. In particular, NCUA estimates that over 90 percent of those credit unions, if subject to the requirements of the proposed rule today, would be in compliance with the minimum risk-based capital requirement under the rule. The Board recognizes, however, that some credit unions would likely need a transition period to accumulate additional capital or change their asset structure to achieve their desired capital classification. The Board also recognizes that credit unions would need a reasonable period of time to update their internal systems, policies, and procedures to account for these changes. As a result, the Board is proposing to delay the effective date of the new requirements after the final rule is published in the **Federal Register**, which is discussed in more detail below.

Using Call Report data as of June 2013, NCUA estimates that approximately 2,237 credit unions reported over $50 million in total assets, all of which would be subject to the proposed risk-based capital measures.

Existing data available to NCUA, including Call Report data, does not contain all of the information required to analyze the impact of every aspect of the proposal. However, NCUA believes the current Call Report data available provides sufficient information for NCUA to reasonably estimate the impact of the proposed regulation. Accordingly, NCUA analyzed the impact of the proposed rule on credit unions using Call Report data as of June 30, 2013.

Over 90 percent of credit unions subject to the proposed capital measures currently hold capital in excess of the minimum net worth ratio and the risk-based capital ratio required to be

[27] *See* U.S. Govt. Accountability Office, GAO–07–253, Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing The Proposed Basel II Framework 9–10 (2007), *available at http://www.gao.gov/new.items/d07253.pdf*.

[28] 12 U.S.C. 1790d.

classified as well capitalized. As of June 2013, the proposed changes to the risk-based capital measure, if applied immediately, would cause 189 credit unions to experience a decline in their PCA classification from well capitalized to adequately capitalized and 10 well capitalized credit unions to experience a decline to undercapitalized. NCUA estimates that, collectively, the 10 credit unions that would experience a decline to undercapitalized would need to retain an additional $63 million in risk-based capital to become adequately capitalized, assuming no other adjustments. Affected credit unions may be required to change internal policies and practices to meet the new risk-based capital requirements of the proposed rule.

Based on June 2013 Call Report data, NCUA estimates that if the proposed risk-based capital requirements were applied today, the aggregate risk-based capital ratio for credit unions subject to the proposed risk-based capital measure would be 14.6 percent and the average risk-based capital ratio would be 15.7 percent. These numbers are well above the proposed 10.5 percent requirement for classification as well-capitalized.

II. Section-by-Section Analysis

Part 702—Capital Adequacy

Revised Structure of Part 702

The proposed rule would retitle current part 702, replacing the current title "Prompt Corrective Action" with the new title "Capital Adequacy." [29] The more general term Capital Adequacy better characterizes the components of proposed part 702, which include the prompt corrective action, minimum regulatory capital measures, and supervisory actions required under section 216 of the FCUA.[30]

The proposed rule would also reorganize part 702 by consolidating NCUA's PCA requirements, which were previously included under subsections A, B, C, and D, under new subparts A and B. Proposed subpart A would be titled "Prompt Corrective Action" and proposed subpart B would be titled "Alternative Prompt Corrective Action for New Credit Unions." [31] The reorganization of the proposed rule is designed so that credit unions need only reference the subpart applying to their institution to identify the applicable minimum capital standards and PCA regulations. The Board believes this consolidation will reduce confusion and avoid credit unions having to frequently flip back and forth through the four subparts of the current PCA rule.

In general, the proposed rule would restructure part 702 by consolidating most of the rules relating to capital and PCA that are applicable to credit unions that are not "new" credit unions under new subpart A. This change is intended to simplify the structure of part 702 by grouping the sections of the rule that are applicable only to credit unions *not* classified as new into a single subpart. The specific sections that would be included in new subpart A and the proposed changes to those sections are discussed in more detail below.

Similarly, the proposed rule would consolidate most of NCUA's rules relating to alternative capital and PCA requirements for "new" credit unions under new subpart B. This change is intended to simplify the structure of part 702 by grouping the sections of the rule that are applicable only to credit unions that are classified as new into one subpart. The sections under new subpart B would remain largely unchanged from the requirements of current part 702 relating to alternative capital and PCA, except for revisions to the sections relating to reserves and the payment of dividends. The specific sections included in new subpart B and the specific changes to the sections under new subpart B are discussed in more detail below.

Section 702.1 Authority, Purpose, Scope, and Other Supervisory Authority

Proposed § 702.1 would remain substantially similar to current § 702.1, but would be amended to update terminology and internal cross references within the section, consistent with the changes being proposed in other sections of part 702. No substantive changes to the section are intended.

Section 702.2 Definitions

Proposed § 702.2 would retain many of the definitions in current § 702.2 with no substantive changes. The proposed rule would, however, remove the paragraph number assigned to each definition under current § 702.2 and reorganize the section so the new and existing definitions are listed in alphabetic order. This reformatting would make § 702.2 more consistent with current §§ 700.2, 703.2 and 704.2 of NCUA's regulations.[32]

In addition, proposed § 702.2 would add a number of new definitions, and amend some existing definitions in § 702.2. These changes are intended to help clarify the meaning of terms used in new part 702. The definitions that would be added, amended, or removed are as follows:

Allowance for loan and lease loss (ALLL). The term "allowance for loan and lease loss (ALLL)" would be defined as reserves that have been established through charges against earnings to absorb future losses on loans, leases financing receivables or other extensions of credit. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Call Report. The proposed rule would define the term "Call Report" as the Call Report required to be filed by credit unions under § 741.6(a)(2). The term Call Report is a common expression within the credit union industry and is defined for clarification.

Capital. The proposed rule would define the term "capital" as the equity, as measured by GAAP, available to a credit union to cover losses. The term capital is a common expression within the financial services industry and is defined for clarification.

Cash equivalents. The proposed rule would define the term "cash equivalents" to mean short-term highly liquid investments that have original maturities of 3 months or less, at the time of purchase; are readily convertible to known amounts of cash; and are used as part of the credit union's cash-management activities. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Commitment. The proposed rule would define the term "commitment" as any legally binding arrangement that obligated the credit union to extend credit or to purchase assets. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

CUSO. The proposed rule would define the term "CUSO" as a credit union service organization as defined in parts 712 and 741.

Delinquent loans. The proposed rule would define the term "delinquent loans" as loans that are 60 days or more

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[29] The Board recently approved a proposed rule regarding capital planning and stress testing that also proposes to change the title of part 702 to "Capital Adequacy." 78 FR 65583 (Nov. 1, 2013).

[30] 12 U.S.C. 1790d.

[31] Under both current § 702.301(b) and proposed § 702.201(b), a credit union is "new" if it is "a federally-insured credit union that both has been in operation for less than ten (10) years and has total assets of not more than $10 million. A credit union which exceeds $10 million in total assets may become 'new' if its total assets subsequently decline below $10 million while it is still in operation for less than 10 years."

[32] 12 CFR 700.2; 12 CFR 703.2; 12 CFR 704.2.

past due and loans placed on nonaccrual status. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Derivatives contract.[33] The proposed rule would define the term "derivatives contract" as, in general, a financial instrument, traded on or off an exchange, the value of which is directly depended upon the value on or more underlying securities, equity indices, debt instruments, commodities, interest rates other derivative instruments, or any agreed upon pricing index or arrangement. Derivatives contracts include interest rate derivatives contracts and any other instrument that poses similar counterparty credit risks. Derivatives contracts also include unsettled securities with a contractual settlement or delivery leg that is longer than the lesser of the market standard for the particular instrument or five business days.

First mortgage real estate loan. The proposed rule would define the term "first mortgage real estate loan" as loans and lines of credit fully secured by first liens on real estate (excluding MBLs), where the original amortization of the mortgage exposure does not exceed 30 years; the loan underwriting took into account all the borrower's obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance) and assessments; and the loan underwriting concluded the borrower is able to repay the exposure using the maximum interest rate that may apply in the first five years, the maximum contract exposure over the life of the mortgage, and verified income.

GAAP. The proposed rule would define the term "GAAP" as generally accepted accounting principles as used in the United States. The term "GAAP" is a common expression within the industry and is defined for clarification.

Goodwill. The proposed rule would define the term "goodwill" as an intangible asset representing the future economic benefits arising from other assets acquired in a business combination (i.e. merger) that are not individually identified and separately recognized. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Intangible assets: The proposed rule would define the term "intangible assets" as those assets that are required to be reported as intangible assets in a credit union's Call Report, including but not limited to purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Investment in CUSO. The proposed rule would define the term "investment in CUSO" as the unimpaired value of the credit union's aggregate CUSO investments as measured under generally accepted accounting principles on an unconsolidated basis. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Identified losses. The proposed rule would define the term "identified losses" to mean those items that have been determined by an evaluation made by a state or federal examiner, as measured on the date of examination, to be chargeable against income, capital and/or valuation allowances such as the allowance for loan and lease losses. The proposed definition would also provide the following examples of identified losses: assets classified as losses, off-balance sheet items classified as losses, any provision expenses that are necessary to replenish valuation allowances to an adequate level, liabilities not shown on the books, estimated losses in contingent liabilities, and differences in accounts that represent shortages.

Loans to CUSO. The proposed rule would define the term "loans to CUSO" as the aggregate outstanding loan balance, available line(s) of credit from the credit union, and guarantees the credit union has made to or on behalf of a CUSO. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Loans transferred with limited recourse. The proposed rule would define the term "loans transferred with limited recourse" as the total principal balance outstanding of loans transferred, including participations, for which the transfer qualified for true sale accounting treatment under GAAP, and for which the transferor credit union retained some limited recourse (i.e. insufficient recourse to preclude true sale accounting treatment). The proposed definition would also clarify that the term does not include transfers that qualify for true sale accounting treatment but contain only routine representation and warranty paragraphs that are standard for sale on the secondary market provided the credit union is in compliance with all other related requirements such as capital requirements. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Mortgage servicing asset. The proposed rule would define the term "mortgage servicing asset (MSA)" as those assets (net of any related valuation allowances) resulting from contracts to service loans secured by real estate (that have been securitized or owned by others) for which the benefits of servicing are expected to more than adequately compensate the services for performing the servicing. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Off-balance sheet items. The proposed rule would define the term "off-balance sheet items" as items such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements that are not included on the balance sheet but are normally included in the financial statement footnotes. The definition would be consistent with the related Call Report field and the definition contained in the Call Report instructions.

Qualifying master netting agreement. The proposed rule would define the term "qualifying master netting agreement" as a written, legally enforceable agreement, provided that: (1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty; (2) the agreement provides the credit union the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, Title II

[33] In May 2013, the Board issued a proposed rule that would permit credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. 78 FR 32191 (May 28, 2013). NCUA is still developing its derivatives rule and had not issued a final rule as of the date this proposal was presented to the Board. However, NCUA anticipates amending this rule to be consistent with any final rule issued by the Board related to the May 2013 derivatives proposal.

of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs; (3) the agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate is a net creditor under the agreement); and (4) in order to recognize an agreement as a qualifying master netting agreement for purposes of part 702, a credit union must conduct sufficient legal review, at origination and in response to any changes in applicable law, to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement meets the requirements of paragraph (2) of the definition of qualifying master netting agreement; and in the event of a legal challenge (including one resulting from default or from conservatorship, receivership, insolvency, liquidation, or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of relevant jurisdictions.

Risk-based capital ratio. The proposed rule would define the term "risk-based capital ratio" as the percentage, rounded to two decimal places, of the risk-based capital numerator to total risk-weighted assets, as calculated in accordance with § 702.104(a).

Risk-weighted assets. The proposed rule would define the term "risk-weighted assets" as the total risk-weighted assets as calculated in accordance with § 702.104(c).

Senior executive officer. The proposed rule would define the term "senior executive officer" as a senior executive officer as defined by § 701.14(b)(2).

Total assets. The proposed rule would retain the definition of "total assets" in current § 702.2, but would restructure the definition and provide additional clarifying language. Under proposed paragraph (1) under the definition of "total assets," for each quarter, a credit union must elect one of the four measures of total assets listed in paragraph (2) of the definition to apply for all purposes under part 702 except §§ 702.103 through 702.105 (risk-based capital ratio requirements). Proposed paragraph (2) under the definition of total assets would provide that "total assets" means a credit union's total assets as measured by either: (i) The credit union's total assets measured by the average of quarter-end balances of the current and three preceding calendar quarters; (ii) the credit union's total assets measured by the average of month-end balances over the three calendar months of the applicable calendar quarter; (iii) the credit union's total assets measured by the average daily balance over the applicable calendar quarter; or (iv) the credit union's total assets measured by the quarter-end balance of the applicable calendar quarter as reported on the credit union's Call Report.

U.S. Government agency. The proposed rule would define the term "U.S. Government agency" as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

Verified income. The proposed rule would define the term "verified income" as receipt and retention of corroborative information to establish the reality of the income supporting the repayment of the loan. The term "verified income" is a common expression within the industry and is defined for clarification.

Weighted-average life. The proposed rule would remove the term "weighted-average life" from current § 702.2 and replace it with the newly defined term "weighted-average life of investments."

Weighted-average life of investments. The proposed rule would move the definition of "weighted-average life of investments" contained within current § 702.105 to proposed § 702.2 and would add additional clarifying language. The weighted-average life of investments for registered investment companies, collective investment funds, money market funds, callable fixed rate debt obligations and deposits, variable rate debt obligations and deposits, capitel in mixed-ownership government corporations, and other equity securities would remain unchanged. The proposal would assign specific risk-weights to investments in CUSOs and capital in corporate credit unions, as addressed below, thus removing them from the weighted-average life measure.

The proposed rule would define the term "weighted-average life of investments" as follows: For investments in registered investment companies (e.g., mutual funds) and collective investment funds (e.g., common trusts), the term "weighted-average life of investments" would mean the maximum weighted-average life or duration target of the investment disclosed, directly or indirectly, in the most recent prospectus or trust instrument (if the maximum weighted-average life or duration target is not disclosed, the weighted-average life of investments means greater than 5 years, but less than 10 years). For investments in money market funds, as defined in 17 CFR 270.2a-7, and collective investment funds operated in accordance with short-term investment fund rules set forth in 12 CFR 9.18(b)(4)(ii)(B)(1) through (3), the term "weighted-average life of investments" would mean 1 year or less. For fixed rate debt obligations and deposits that are callable in whole, the term "weighted-average life of investments" would mean the period remaining to the maturity date. For fixed rate debt obligations and deposits that are non-callable and non-amortizing (e.g. bullet maturity instruments), the term "weighted-average life of investments" would mean the period remaining to the maturity date. For fixed rate debt obligations or deposits with periodic principal pay downs (e.g., mortgage-backed securities), the term "weighted-average life of investments" would be defined according to industry standard calculations, which include the impact of unscheduled payments. For variable rate debt obligations and deposits (regardless of whether the investment amortizes), the term "weighted-average life of investments" would mean the period remaining to the next rate adjustment date. For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), the term "weighted-average life of investments" would mean greater than 1 year but less than or equal to 3 years. For other equity securities, the term "weighted-average life of investments" would mean greater than 10 years. For any other investments not addressed above, the term "weighted-average life of investments" would mean the average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time), and then taking the total of these time-weighted payments and dividing by the total amount of principal. The proposed definition of weighted-average life of investments reflects the current method used by credit unions to report investments on the Statement of Financial Condition on the Call Report. The definition has remained largely unchanged from when the risk-based net worth requirements of part 702 were first implemented.[34]

[34] See 65 FR 8597 (Feb. 18, 2000) (providing that: "The definition [of weighted-average life] is adopted in modified form from Fabozzi, Frank and T. Dessa, eds., *The Handbook of Fixed Income Securities* (4th ed. 1995) at 518, and reflects the

A. Subpart A—Prompt Corrective Action

The proposed rule would establish new subpart A titled "Prompt Corrective Action." New subpart A would contain the sections of part 702 relating to capital measures, supervisory PCA actions, requirements for net worth restoration plans, and reserve requirements for all credit unions *not* defined as "new" pursuant to section 216(b)(2) of the FCUA.[35]

Section 702.101 Capital Measures, Effective Date of Classification, and Notice to NCUA

The requirements of proposed § 702.101 would remain largely unchanged from current § 702.101. The title of proposed § 702.101, however, would be changed to "Capital measures, effective date of classification, and notice to NCUA" to better reflect the three major topics that would be covered in the section. In addition, the proposed rule would replace the terms "net worth measures" with "capital measure," "net worth classification" with "capital classification," and "net worth category" with "capital category" to reflect the terminology changes being made throughout the proposed rule, which were discussed above and are discussed in further detail below.

Section 702.102 Capital Classifications

The proposal would change the title of § 702.102 from "Statutory net worth categories" to "Capital classifications." Although section 216(c) of the FCUA uses the general term "net worth categories," NCUA believes that replacing the term "net worth" with the general term "capital categories" better describes the combined "net worth ratio" and "risk-based net worth" measurements that make up the five categories listed in the statute. Moreover, the term "capital" is generally more inclusive of all accounts available to pay losses than the term "net worth" and is more commonly used in the financial services industry. No substantive changes to the requirements of section 216(c) are intended by these changes in terminology. This section would continue to list the five statutory capital categories that are provided in section 216(c) of the FCUA.[36]

102(a) Capital Categories

Proposed § 702.102(a) would replace current § 702.102(a) and would set forth new minimum capital measures for complex credit unions. Although sections 216(c)(1)(A)(ii), (B)(ii), (C)(ii) and 216(d) of the FCUA use the term "risk-based net worth" requirement, NCUA believes that replacing the term "risk-based net worth" with the functionally equivalent term "risk-based capital" in the proposed rule would better describe the equity and assets the requirement would measure. Moreover, the term "risk-based capital" is more commonly used in the financial services industry, and is defined in a manner consistent with the requirements set forth in section 216. No changes to the requirements of the statute are intended by the use of the alternative term risk-based capital in the proposed rule.

Consistent with subsections 216(c)(1)(A) through (E) of the FCUA, the net worth ratio measures listed in proposed §§ 702.102(a)(1) through (5) would continue to match those listed in the statute for each capital category, and would use both the net worth ratio and the new risk-based capital ratio as elements of the capital categories for "well capitalized", "adequately capitalized" and "undercapitalized" credit unions. The risk-based capital ratio measure complements the net worth ratio, and section 216(d) of the FCUA requires the risk-based capital requirement be designed "to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." Accordingly, the risk-based capital ratio includes components that require higher capital levels to reflect increased risk due to interest rate risk, concentration risk, credit risk, market risk, and liquidity risk.

In essence, the current RBNW requirement is evaluated on a pass/fail basis. The proposed rule, in contrast, would introduce a new scaled risk-based capital measurement approach for assigning capital classifications for well capitalized, adequately capitalized, and undercapitalized credit unions. This scaled approach would recognize the relationship between higher risk-based capital ratios and the creditworthiness of credit unions.

TABLE 4—PROPOSED CAPITAL CATEGORIES

A credit union's net worth classification is . . .	Net worth ratio	Risk-based capital ratio *	And subject to following condition(s) . . .
Well Capitalized	7% or above	10.5% or above	Must pass both net worth ratio and risk-based capital ratio.
Adequately Capitalized	6% to 6.99%	8% to 10.49%	Must pass both net worth ratio and risk-based capital ratio.
Undercapitalized	4% to 5.99%	Less than 8%	Must pass both net worth ratio and risk-based capital ratio.
Significantly Undercapitalized.	2% to 3.99%	N/A	Or if undercapitalized at <5% net worth and fails to timely submit or materially implement an approved net worth restoration plan.
Critically Undercapitalized	Less than 2%	N/A	None.

* Applies only to credit unions with quarter-end total assets exceeding $50 million.

method by which credit unions report investments in Schedule C of the Call Report.").

[35] 12 U.S.C. 1790d(b)(2).

[36] 12 U.S.C. 1790d(c).

102(a)(1) Well Capitalized

Under proposed § 702.102(a)(1), to be classified as well capitalized, a credit union must maintain a net worth ratio of 7 percent or greater and, if a complex credit union, must also have a risk-based capital ratio of 10.5 percent or greater. The higher proposed risk-based capital requirement for the well capitalized classification is designed to bolster the resiliency of complex credit unions throughout financial cycles. The proposed 10.5 percent risk-based capital ratio target is comparable to the Other Federal Banking Regulatory Agencies' 8 percent Total Risk-based Capital ratio plus the 2.5 percent capital conservation buffer which is expected to be fully implemented in 2019.[37] NCUA is proposing the 10.5 percent risk-based capital ratio requirement, rather than the Other Federal Banking Regulatory Agencies' 8 percent, to avoid the complexity of implementing a capital conservation buffer.

102(a)(2) Adequately Capitalized

Under proposed § 702.102(a)(2), to be classified as adequately capitalized, a credit union must maintain a net worth ratio of 6 percent or greater and, if a complex credit union, must also have a risk-based capital ratio of 8 percent or greater. For example, a complex credit union with an 8 percent net worth ratio and an 8.5 percent risk-based capital ratio would be adequately capitalized under the proposed rule. The 8 percent risk-based capital ratio requirement for the credit union industry is a measure comparable to the 8 percent total risk-based capital ratio required by the Other Federal Banking Regulatory Agencies' for a bank to be adequately capitalized.

102(a)(3) Undercapitalized

Under proposed § 702.102(a)(3), to be classified as undercapitalized, a credit union must maintain a net worth ratio of 4 percent or greater and, if a complex credit union, fail to meet the minimum 8 percent total risk-based capital ratio requirement. For example, a complex credit union with an 8 percent net worth ratio and a 7.5 percent risk-based capital ratio would be undercapitalized under the proposed rule.

102(a)(4) Significantly Undercapitalized

Under proposed § 702.102(a)(4), a credit union is classified as significantly undercapitalized if: (1) It has a net worth ratio of less than 5 percent, and has received notice that its net worth restoration plan has not been approved;[38] (2) the credit union has a net worth ratio of 2 percent or more but less than 4 percent; or (3) the credit union has a net worth ratio of 4 percent or more but less than 5 percent, and the credit union either fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.111, or materially fails to implement a net worth restoration plan approved by NCUA. Although proposed § 702.102(a)(4) has been worded differently to help clarify the requirements of the paragraph, the proposed rule would not change the criteria for being classified as significantly undercapitalized under part 702.

102(a)(5) Critically Undercapitalized

Under proposed § 702.102(a)(5), a credit union is classified as critically undercapitalized if it has a net worth ratio of less than 2 percent. The proposal would not change the criteria for being classified as critically undercapitalized.

102(b) Reclassification Based on Supervisory Criteria Other Than Net Worth

Proposed § 702.102(b) would remain mostly unchanged from current § 702.102(b), with only a few amendments to update terminology and make minor edits for clarity. No substantive changes are intended.

102(c) Non-Delegation

Proposed § 702.102(c) would be unchanged from current § 702.102(c).

102(d) Consultation With State Officials

Proposed § 702.102(d) would remain mostly unchanged from current § 702.102(d), with only a few small amendments for consistency with other sections of NCUA's regulations. No substantive changes are intended.

Section 702.103 Applicability of Risk-Based Capital Ratio Measure

Proposed § 702.103 would change the title of current § 702.103 from "Applicability of risk-based net worth requirement" to "Applicability of risk-based capital ratio measure." Proposed § 702.103 would provide that, for purposes of § 702.102, a credit union is defined as "complex," and a risk-based capital ratio requirement is applicable, only if the credit union's quarter-end total assets exceed $50 million, as reflected in its most recent Call Report. The proposal would eliminate current § 702.103(b) and define all credit unions with over $50 million in assets as "complex." Under the current rule, credit unions are "complex" and subject to the RBNW requirement only if they have quarter-end total assets over $50 million *and* they have an RBNW over 6 percent. In the proposed rule all credit unions with total quarter end assets over $50 million would be considered "complex" and subject to the risk-based capital ratio.

In January 2013, NCUA revised part 702 by increasing the asset size of credit unions subject to the risk-based net worth requirement from $10 million to $50 million.[39] In setting the $50 million asset threshold, the Board considered the following factors for a variety of asset size ranges:

- The percentage of industry assets and units;
- Credit union complexity as measured by products and services;
- The history of failures; and
- The risk to the NCUSIF.

NCUA estimates that, as of June 30, 2013, approximately 2,237 of 6,681 credit unions reported total assets over $50 million. These credit unions hold approximately 94 percent of total credit union system assets.

Section 702.104 Risk-Based Capital Ratio Measures

Proposed § 702.104 would change the title of current § 702.104 from "Risk portfolio defined" to "Risk-based capital ratio measures." Proposed § 702.104 would entirely replace the requirements for calculating the RBNW requirement for "complex" credit unions under current § 702.104 with a new risk-based capital ratio requirement.[40] The proposed section would require all "complex" credit unions to calculate the risk-based capital ratio as directed in this section. The proposed risk-based capital ratio is designed to enhance sound capital management and help ensure that credit unions maintain adequate levels of loss-absorbing capital going forward, strengthening the stability of the credit union system and ensuring credit unions serve as a source of credit in times of stress.

[37] On September 10, 2013, FDIC published an interim final rule that revised it risk-based and leverage capital requirements for FDIC-supervised institutions. 78 FR 55339 (Sept. 10, 2013).

[38] To qualify for a higher net worth classification, a significantly undercapitalized credit union must have a net worth restoration plan approved by NCUA.

[39] On January 18, 2013, NCUA published a final rule and IRPS 13–1 redefining "small entity" as a credit union with less than $50 million in assets and amending 12 CFR 702.103 increasing to $50 million the asset threshold used to define "complex" credit union for determined whether RBNW requirements apply. 78 FR 4032 (Jan. 18, 2013).

[40] 12 U.S.C. 1790d(d).

104(a) Calculation of Capital for the Risk-Based Capital Ratio

Proposed § 702.104(a) would provide that to determine its risk-based capital ratio, a complex credit union must calculate the percentage, rounded to two decimal places, of its risk-based capital numerator as described in § 702.104(b) to its total risk-weighted assets denominator as described in § 702.104(c). In simplest terms, the proposed risk-based capital ratio would be the percentage of a defined measure of the equity and other accounts held by a credit union that are available to cover losses, divided by a defined risk-weighted asset base. The proposed method of calculating risk-based capital would be generally consistent with the methods used in other sectors of the financial services industry. Conversely, the method of computing the RBNW measure in current § 702.104 is unique within the financial services industry, and frequently results in confusion and incorrect analyses when industry analysts attempt to compare credit union risk-weights for assets to bank risk-weights for assets. As with the current RBNW ratio, the proposed risk-based capital ratio calculation would be calculated primarily using information credit unions already report on the Call Report form required under § 741.6(a)(2) of NCUA's regulations.

104(b) Risk-based Capital Ratio Numerator

Proposed § 702.104(b) would provide that the risk-based capital numerator is the sum of the specific certain capital elements listed in § 702.104(b)(1), minus certain regulatory adjustments listed in § 702.104(b)(2). The proposed numerator for the risk-based capital ratio would continue to consist primarily of the components of a credit union's net worth. In order to capture all of the material risks while keeping the calculation from becoming overly complex, the proposed rule would add some additional equity items and other specified balance sheet items would be subtracted. The goal of the proposed risk-based capital ratio numerator is to achieve a measure that reflects a more accurate amount of equity and reserves available to cover losses.

TABLE 5—PROPOSED RISK-BASED CAPITAL NUMERATOR

Additions	Deductions
Undivided earnings (includes any regular reserve)	NCUSIF deposit.
Appropriations for non-conforming investments	Goodwill.
Other reserves	Other intangible assets.
Equity acquired in merger	Identified losses not reflected as adjustments to components of the risk-based numerator.
Net income.	
ALLL (limited to 1.25% of risk assets).	
Secondary capital accounts included in net worth.	
Section 208 assistance included in net worth (as defined in § 702.2).	

104(b)(1) Capital Elements of the Risk-Based Capital Ratio Numerator

Proposed § 702.104(b)(1) would list the capital elements of the risk-based capital numerator as follows:

- Undivided earnings (includes any regular reserve);
- Appropriation for non-conforming investments;
- Other reserves;
- Equity acquired in merger;
- Net income;
- ALLL, limited to 1.25% of risk assets;
- Secondary capital accounts included in net worth (as defined in § 702.2); and
- Section 208 assistance included in net worth (as defined in § 702.2).

The proposed risk-based numerator would include the equity acquired in merger component of the balance sheet. This equity item would be used in place of the total adjusted retained earnings acquired through business combinations amount credit unions report on the PCA Net Worth Calculation Worksheet in the Call Report. The equity acquired in merger is the GAAP equity recorded in a business combination and can vary from the amount of total adjusted retained earning acquired through business combinations, which is not a GAAP accounting item. The use of equity acquired in a merger, as measured using GAAP, more accurately reflects the overall value of the business combination transaction.

Because the ALLL is available to cover expected levels of loan losses, the proposed numerator also would include the ALLL, but it would be limited to 1.25 percent of total risk-weighted assets.[41] The RBNW calculation for ALLL in current § 702.104(h) is limited to 1.50 percent of loans and is included as a reduction in the level of risk assets. By establishing a limit in the amount of ALLL included in the numerator, the proposed rule would provide an incentive for granting quality loans and recording loan losses in a timely manner. The proposed 1.25 percent limit should not result in a disincentive to fully fund the ALLL above the 1.25 percent ceiling, because complex credit unions are bound by GAAP in maintaining the ALLL. NCUA estimates that, as of June 30, 2013, approximately 468 of the 2,237 "complex" credit unions have an ALLL greater than 1.25 percent of total risk assets.

The proposed risk-based capital numerator would not include the following Call Report equity items:

- Accumulated unrealized gains (losses) on available for sale securities;
- Accumulated unrealized losses for OTTI on debt securities;
- Accumulated unrealized net gains (losses) on cash flow hedges; and
- Other comprehensive income.

NCUA recognizes the items listed above reflect a credit union's actual loss absorption capacity at a specific point in time, but includes gains or losses that may or may not be realized. NCUA also recognizes that including these items in the risk-based numerator could lead to volatility in the risk-based capital measure, difficulty in capital planning and asset-management and other unintended consequences.[42] Accordingly, NCUA chose to exclude these items from the proposed risk-based capital numerator.

104(b)(2) Risk-Based Capital Numerator Deductions

Proposed § 702.104(b)(2) would provide that the elements deducted

[41] The 1.25 percent of risk-weighted assets limitation is consistent with the Basel III framework and the regulatory capital rules for U.S. banks.

[42] The Other Federal Banking Agencies' regulatory capital rules (12 CFR 324.22) allow institutions to make an opt-out election for similar accounts. See, e.g., 78 FR 55339 (Sept. 10, 2013).

from the sum of the risk-based capital elements are:

- NCUSIF Capitalization Deposit;
- Goodwill;
- Other intangible assets; and
- Identified losses not reflected in the risk-based capital ratio numerator.

In order to achieve a risk-based capital numerator reflecting equity available to cover losses in the event of liquidation, goodwill and other intangible assets would be deducted from both the risk-based capital numerator and denominator. Goodwill and other intangible assets contain a high level of uncertainty regarding a credit union's ability to realize value from these assets, especially under adverse financial conditions.

The proposed rule would address concerns about the NCUSIF deposit reflected on the NCUSIF's balance sheet both as equity to pay losses and as an asset of the insured credit unions. In the proposed rule, the NCUSIF deposit is subtracted from both the numerator and denominator of the risk-based capital ratio.[43] This treatment for the risk-based regulatory capital standard would not alter the NCUSIF deposit accounting treatment for credit unions.

The proposed rule would include a provision to allow for identified losses, not otherwise reflected as adjustments in the risk-based capital numerator, to be deducted to reflect an accurate risk-based capital ratio. The inclusion of identified losses would allow for the calculation of an accurate risk-based capital ratio. Examples of items that would be subject to this provision include shortages in the ALLL, underfunded pension accounts, and unsupported valuations of bond claim receivables.

104(c) Total Risk-Weighted Assets

In developing the proposed risk-weights, NCUA reviewed the Basel accords and both the U.S. and international banking system's existing risk-weight measures.[44] NCUA considered the comments contained in material loss reviews prepared by the NCUA Inspector General and GAO comments in their reviews of the financial services industry's implementation of PCA.[45] As previously mentioned, because the FCUA requires the risk-based measure to include all material risks, consideration was given to credit risk, concentration risk, market risk, interest rate risk, operational risk, and liquidity risk.

Proposed § 702.104(c) would address concentration risk by assigning higher risk-weights to larger percentages of assets in MBLs and real estate loans. The concentration threshold amounts are generally based on the average percentage of assets held in the asset types.

104(c)(1) General

Proposed § 702.104(c)(1) would provide that total risk-weighted assets include risk-weighted on-balance sheet assets as described in § 702.104(c)(2), plus the risk-weighted off-balance sheet assets in § 702.104(c)(3), plus the risk-weighted derivatives in § 702.104(c)(4), minus the risk-based capital numerator deductions in § 702.104(b)(2). The proposal would require a complex credit union to calculate its risk-weighted asset amount for its on- and off-balance sheet exposures. (NCUA's Call Report system would be upgraded to conduct the calculations automatically.) In the proposal, risk-weighted asset amounts would generally be determined by assigning an on-balance sheet asset to broad risk-weight categories according to the asset type, collateral, and level of concentration. Similarly, risk-weighted assets amounts for off-balance sheet items would be calculated using a two-step process: (1) Multiplying the amount of the off-balance sheet exposure by a credit conversion factor (CCF) to determine a credit equivalent amount, and (2) assigning the credit equivalent amount to a relevant risk-weighted category. A credit union would determine its total risk-weighted assets by calculating (1) its risk-weighted assets, minus (2) goodwill and other intangibles, and minus (3) the NCUSIF deposit.

104(c)(2) Risk-Weights for On-Balance Sheet Assets

Proposed § 702.104(c)(2) would define the risk categories and risk-weights to be assigned to each specifically defined on-balance sheet asset. All on-balance sheet assets would be assigned to one of the categories and risk-weights listed in Table 6.

TABLE 6—RISK-WEIGHT CATEGORIES AND ASSOCIATED RISK-WEIGHTS

Risk-weight category	Risk-weight	Items included
Category 1	0 percent	• Cash on hand, which includes the change fund (coin, currency, and cash items), vault cash, vault funds in transit, and currency supplied from automatic teller machines. • NCUSIF capitalization deposit. • Debt instruments unconditionally guaranteed by the NCUA or the FDIC. • U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government, including U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS). • Non-delinquent student loans unconditionally guaranteed by a U.S. Government agency.
Category 2	20 percent	• Cash on deposit, which includes balances on deposit in insured financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check, and they may or may not bear interest. Examples include overnight accounts, corporate credit union daily accounts, money market accounts, and checking accounts. • Cash equivalents (investments with original maturities of three months or less). Cash equivalents are short-term, highly liquid non-security investments that have an original maturity of 3 months or less at the time of purchase, are readily convertible to known amounts of cash, and are used as part of the credit union's cash management activities. • The total amount of investments with a weighted-average life of one year or less. • Residential mortgages guaranteed by the federal government through the FHA or the VA.

[43] *See* U.S. Govt. Accountability Office, GAO–04–849, Available Information Indicates No Compelling Need for Secondary Capital (2004), *available at http://www.gao.gov/assets/250/243642.pdf*.

[44] The Basel Committee on Banking Supervision (BCBS) published Basel III in December 2010 and revised it in June 2011, *available at http://www.bis.org/publ/bcbs189.htm*.

[45] Section 988 of the Dodd-Frank Wall Street Reform and Consumer Protection Act obligates the NCUA's Inspector General to conduct material loss reviews (MLRs) of credit unions that incurred a loss of $25 million or more to the NCUSIF. In addition, section 988 requires the NCUA's Inspector General to review all losses under the $25 million threshold to assess whether an in-depth review is warranted due to unusual circumstances. The MLRs are available at *http://www.ncua.gov/about/Leadership/CO/OIG/Pages/MaterialLossReviews.aspx; see also* GAO/GGD–98–153 (July 1998); GAO–07–253 (Feb. 2007), GAO–11–612 (June 2011), GAO–12–247 (Jan. 2012), and GAO–13–71 (Jan. 2013).

TABLE 6—RISK-WEIGHT CATEGORIES AND ASSOCIATED RISK-WEIGHTS—Continued

Risk-weight category	Risk-weight	Items included
		• Loans guaranteed 75 percent or more by the SBA, U.S. Department of Agriculture, or other U.S. Government agency.
Category 3	50 percent	• The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years.
		• The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.
Category 4	75 percent	• The total amount of investments with a weighted-average life of greater than three years, but less than or equal to five years.
		• Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans (STS), new vehicle loans, used vehicle loans, leases receivable and all other loans; (Excluding loans reported as MBLs).
		• Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.
Category 5	100 percent	• Corporate credit union nonperpetual capital.
		• The total outstanding principal amount loaned to CUSOs.
		• Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets.
		• Delinquent first mortgage real estate loans.
		• Other real estate-secured loans less than or equal to 10 percent of assets.
		• MBLs less than or equal to 15 percent of assets.
		• Loans held for sale.
		• The total amount of any foreclosures and repossessed assets.
		• Land and building, less depreciation on building.
		• Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation.
		• Current non-federally insured student loans.
		• All other assets not specifically assigned a risk-weight but included in the balance sheet.
Category 6	125 percent	• Total amount of all other real estate-secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets.
Category 7	150 percent	• The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years.
		• Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding loans reported as MBLs).
		• The total amount of all other real estate-secured loans greater than 20 percent of assets.
		• Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets.
Category 8	200 percent	• Corporate credit union perpetual capital.
		• The total amount of investments with a weighted-average life of greater than 10 years.
		• The total amount of MBLs greater than 25 percent of assets, other than MBLs included in Category 3 above.
Category 9	250 percent	• The total value of investments in CUSOs.
		• The total value of mortgage servicing assets.
Category 10	1,250 percent	• An asset-backed investment for which the credit union is unable to demonstrate, as required under §702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance.

A further explanation of risk-weights based on balance sheet asset type follows.

Cash and investment risk-weights. The proposal generally would maintain the existing structure for measuring risk-weights for most cash items and investments. For specific investments, the risk-weights would continue to be based upon the "weighted-average life of investments" (WAL), as defined within the regulation. The WAL is generally the average time until a dollar of principal is repaid.

TABLE 7—PROPOSED RISK-WEIGHTS FOR CASH AND INVESTMENTS

Item	Proposed risk-weight (percent)
Cash on hand	0
NCUA and FDIC Issued Guaranteed Notes	0
Direct, unconditional U.S. Government obligations	0
Cash on deposit	20
Cash equivalents	20
Total investments with WAL ≤ 1-year	20
Total investments with WAL >1-year and ≤ 3-years	50
Total investments with WAL >3-year and ≤ 5-years	75
Corporate credit union nonperpetual capital	100
Total investments with WAL >5-year and ≤ 10-years	150
Total investments with WAL > 10-years	200

TABLE 7—PROPOSED RISK-WEIGHTS FOR CASH AND INVESTMENTS—Continued

Item	Proposed risk-weight (percent)
Corporate credit union perpetual capital	200

Cash held by a credit union for normal operations—such as vault cash, ATM cash, and teller cash—typically present no risk because it is protected from loss by a credit union's fidelity bond and would be assigned a zero risk-weight.

To maintain continuity and provide a fair measure of the interest rate and liquidity risks associated with longer term investments, the proposed rule would continue to use the measure in current § 702.105 for investments. The current risk-weights for investments relied on the results of 300 basis point interest rate "shock tests" to corroborate the assigned risk-weights. The 300 basis point shock test is a widely accepted measure of interest rate risk. The proposed risk-weight for investments with a WAL of less than 5 years would be lower, relative to the existing rule, to reflect lower interest rate risk and liquidity risk. The proposed risk-weight for investments with a WAL from 5 to 10 years would be about the same and the risk-weight for investments with a WAL over 10 years would be decreased slightly.

The proposal would lower the risk-weight for direct and unconditional U.S. Government obligations (FDIC issued Guaranteed Notes, and other U.S. Government obligations) from the WAL measure to zero risk-weighted assets, and maintain the current zero risk-weight for NCUA Guaranteed Notes.

In the current rule, the investment in nonperpetual and perpetual capital in a corporate credit union are reported in the ">1–3 Years" WAL bucket on the Call Report and assigned the associated risk-weight.

Member Business Loans (MBLs). Consistent with the existing rule, the risk portfolio for "member business loans outstanding" in the proposal will consist of loans outstanding that qualify as MBLs under NCUA's definition,[46] or under a state's NCUA-approved definition.[47] If a loan qualifies as a MBL when it is originated, it will remain so until it has been repaid in full, sold, or otherwise disposed of. Unused MBL commitments would be addressed in a separate off-balance sheet risk portfolio.

In the current rule, the risk-weights for MBLs apply across three thresholds based on the amount of MBLs as a percentage of total assets. The first threshold applies to concentrations between 0 and 15 percent, the second applies to concentrations over 15 percent and up to 25 percent, and the third applies to concentrations in excess of 25 percent. The proposed rule would maintain the same threshold levels for assigning risk-weights. Since current MBL regulations generally limit MBLs to 12.25 percent of total assets,[48] typically only those credit unions with an MBL exemption are subject to the higher risk-weightings assigned to the higher concentrations of MBLs.

Supervisory experience has demonstrated that certain MBLs present multiple risks for which credit unions should hold additional capital. Many of the largest losses to the NCUSIF occurred in credit unions with high concentrations of MBLs.[49] Similarly, the failures of many small banks between 2008 and 2011 were also largely driven by high concentrations of MBLs. The GAO reported that in the 10 states with 10 or more bank failures between 2008 and 2011, the failure of the small and medium-size banks were largely associated with high concentrations of commercial real estate loans.[50]

As illustrated in Table 8, the proposed rule would moderately increase all of the risk-weights for MBLs.

TABLE 8—COMPARISON OF CURRENT REGULATION AND PROPOSED MBL COMPONENT

Total MBLs	Current MBL risk-weightings [51]—(converted for 8% adequately capitalized level) (percent)	Proposed MBL risk-weightings (percent)
0 to 15% of Assets	75	[52] 100
>15 to 25% of Assets	100	150
Amount over 25%	175	200

MBLs that are government guaranteed at least 75 percent, normally by the Small Business Administration (SBA) or U.S. Department of Agriculture, would receive a lower risk-weight of 20 percent under the proposed rule.

As of June 2013, for the 1,579 complex credit unions with outstanding MBLs, MBLs comprise an aggregate of

[46] *See* 12 CFR 723.1.

[47] *See* 12 CFR 723.20.

[48] *See* 12 CFR 723.16(a).

[49] *See* NCUA Office of the Inspector General, OIG–10–20, OIG Capping Report on Material Loss Reviews (Nov. 23, 2010), Chart G, *available at http://www.ncua.gov/about/Leadership/CO/OIG/Documents/OIG201020CappRpt.pdf.*

[50] U.S. Government Accountability Office, GAO–13–704T, Causes and Consequences of Recent Community Bank Failures (June 12, 2013), page 4, *available at http://www.gao.gov/assets/660/655193.pdf.*

[51] The current MBL risk-weightings were converted to a comparable risk-weight by dividing the current risk-weighting by 8 percent, with 8 percent representing the level of risk-weighted capital needed to be adequately capitalized. In the current rule total MBLs less than the threshold 15 percent of assets receive a 6 percent risk-weighting, which is equivalent to a 75 percent risk-weight under this proposal (6% divided by 8%). The next threshold in the current regulation for total MBLs from 15 percent to 25 percent of assets received an 8 percent risk-weighting, which is equivalent to a 100 percent risk-weight under this proposal (8% divided by 8%) and the highest concentrations of MBLs received a 14 percent risk-weight, which is equivalent to a 175 percent risk-weight under this proposal (14% divided by 8%).

[52] This is consistent with the Other Federal Banking Regulatory Agencies' capital rules (e.g., 12 CFR 324.32), which maintain a 100 percent risk-weight for commercial real estate (CRE) and includes a 150 percent risk-weigh for loans defined as high volatility commercial real estate (HVCRE). *See, e.g.*, 78 FR 55339 (Sept. 10, 2013).

4.80 percent of assets and an average 5.14 percent of assets. Only 70 of the credit unions holding MBLs have MBL portfolios in excess of 15 percent of total assets. The threshold of 15 percent was selected to provide for the possibility of a decline in asset size once a credit union reaches the 12.25 percent statutory limit for MBLs.

NCUA considered developing an alternative version of the current method for computing the MBL's 15 percent concentration level that would have addressed the potential for reduced risk in a well-diversified MBL portfolio. However, before developing such a method, NCUA staff evaluated the diversity of MBL loan types using the data reported in the Call Report. The data was summarized into the following five subcategories: (1) Construction and development, (2) agriculture related loans, (3) non-farm, non-residential property, (4) commercial and industrial loans, and (5) unsecured business loans. NCUA noted as they evaluated the Call Report data that, of the 70 credit unions with MBLs over the 15 percent of assets threshold that would be subject to higher risk-weights on a portion of their MBLs, most tended to primarily originate one particular type of MBL. The Call Report data provides no information on the geographic distribution of the MBL portfolio and the additional information needed to properly identify the nature and extent of any diversification would place an additional data reporting burden on credit unions with an uncertain result. Due to the lack of diversity in the types of MBLs held by credit unions and the reporting requirements to potentially identify diversification, the Board decided to propose maintaining the current risk-weight concentration levels. The Board believes that maintaining the current methodology avoids adding the complexity required to define the adequate level of diversification and associated reporting necessary to implement such an alternative method in the proposed rule.

Real Estate Loans. The current rule excludes from the real estate risk-weights those real estate loans reported as MBLs. The proposed rule would continue this exclusion.

The current standard risk-weighting approach establishes higher capital requirements only for "long term" real estate loans, excluding loans that re-price, refinance, or mature within five years or less. By excluding loans that re-price, refinance, or mature within five years or less from higher capital requirements, the current formula does not address a large amount of real estate loans. As a result, credit unions build real estate loan concentrations without appropriate capital. Additionally, the junior lien real estate loans, with a significantly higher loss history, are combined with first mortgage real estate loans. An unintended consequence of the current real estate loan risk-weight is the structuring of mortgage products to minimize capital requirements which could impact the marketability of such loans.

The proposed rule would recognize the lower loss history for current, prudently written first lien real estate-secured loans by assigning a lower risk-weight of 50 percent to the first 25 percent of assets.[53] To account for concentration risk, the risk-weight for first lien real estate loans would increase for loans between 25 and 35 percent of assets from 50 percent to 75 percent. First lien real estate loans over 35 percent of assets would be accorded a 100 percent risk-weight. The threshold of 25 percent is based on the average percent of first mortgage real estate loans to total assets, which, as of June 30, 2013, is 24.9 percent for all complex credit unions. Out of the 2,188 complex credit unions with first mortgage real estate loans, 510 have a concentration in excess of 25 percent of assets and 160 have a concentration in excess of 35 percent of assets.

In the proposed rule, if a credit union holds the first and junior lien(s) on a property, and no other party holds an intervening lien, the credit union could treat the combined exposure as a single loan secured by a first lien for purpose of assigning a risk-weight. A first lien real estate loan could be assigned to the 50 percent risk-weight category only if it is not restructured or modified. A first lien real estate loan modified or structured on a permanent or trial basis solely pursuant to the U.S. Treasury's Home Affordability Mortgage Program (HAMP) would not be considered to be restructured or modified. A first lien real estate loan guaranteed by the federal government through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) generally would be risk-weighted at 20 percent. While a government guarantee against default mitigates credit risk, it does not affect interest rate risk.

During the recent market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures. The cause for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards, high-risk mortgage products providing for negative amortization and significant payment shock to the borrowers, unverified or undocumented income, and a rise in unemployment.[54] Therefore, NCUA is proposing that real estate-secured loans not meeting the definition of first mortgage real estate loans would be referred to as "other real estate loans" and assigned a higher risk-weight. First lien real estate loans delinquent for 60 days or more or carried on non-accrual status would be included in the category of other real estate loans for the purpose of assigning the risk-weight.

In the proposed rule, other real estate loans would be assigned a risk-weight of 100 percent for the first 10 percent of assets. To account for concentration risk, the risk-weight for other real estate loans would increase to 125 percent for loans between 10 and 20 percent of assets. Other real estate loans over 20 percent of assets would be risk-weighted 150 percent. The threshold of 10 percent is roughly based on the average percent of other real estate loans to total assets, which, as of June 30, 2013, is 6.85 percent for all complex credit unions. Out of the 2,218 complex credit unions with other real estate loans, 533 have a concentration in excess of 10 percent of assets and 100 have a concentration in excess of 20 percent of assets.

Tables 9, 10, and 11 below provide a comparison of current and proposed risk-weights for real estate-secured loans:

TABLE 9—CURRENT RISK-WEIGHTS FOR LONG TERM REAL ESTATE LOANS

Current Risk-Weights for Long-Term Real Estate Loans (revised for an 8 percent adequately capitalized standard)

Definition: RE Loans—Loans Maturing, Refinancing, or Re-Pricing in 5 years—RE Loans also reported as MBLs = Long-Term RE Loans.

Threshold	Current risk-weight [55] (percent)
0–25% of assets	75
Excess over 25% of assets	175

[53] This is consistent with the Other Federal Banking Regulatory Agencies' capital rules (e.g., 12 CFR 324.32), which maintained the 50 percent risk-weight for one to four family real estate loans that are prudently underwritten, not 90 days or more past due, and not restructured or modified, and a 100 percent risk-weight for such loans otherwise. *See, e.g.*, 78 FR 55339 (Sept. 10, 2013).

[54] In drafting these proposed regulations, NCUA is mindful of the implications of other recently published regulations that have been issued to improve the quality of mortgage underwriting.

TABLE 10—PROPOSED RISK-WEIGHTS FOR FIRST LIEN REAL ESTATE LOANS

Proposed Risk-Weights for First Lien Real Estate Loans

Definition: 1st Lien RE Loans—1st Lien RE Loans also reported as MBLs—Delinquent 1st Lien RE Loans = First Lien RE Loans.

Threshold	Proposed risk-weight (percent)
0–25% of assets	50
>25–35% of assets	75
Excess over 35% of assets	100

TABLE 11—PROPOSED RISK-WEIGHTS FOR JUNIOR LIEN REAL ESTATE LOANS

Proposed Risk-Weights for Junior Lien Real Estate Loans

Definition: Junior Lien RE Loans + Delinquent 1st Lien RE Loans—Junior Lien RE Loans also reported as MBLs = Junior Lien Real Estate Loans.

Threshold	Proposed risk-weight (percent)
0–10% of assets	100
>10–20% of assets	125
Excess over 20% of assets	150

The aggregate minimum capital requirement, using the proposed risk-weights for first lien and junior lien real estate loans, is slightly less than the current minimum requirement.[56] The proposed risk-weights for real estate loans, however, would result in a higher variance in the minimum capital requirement for individual affected credit unions because the risk-weights better differentiate the risk associated with lien position and concentration.

Current consumer loans. Consumer loans (unsecured credit card loans, lines of credit, automobile loans, and leases) are generally highly desired credit union assets and a key element of providing basic financial services. For most current consumer loans, the proposed rule would assign a risk-weight of 75 percent, which maintains the existing risk-based capital requirement.[57] Non-federally guaranteed student loans, which contain higher risks (e.g., default risk and extension risk), would be risk-weighted at 100 percent in the proposal. Federally guaranteed student loans would receive a zero percent risk-weight.[58] Table 12 below lists the proposed risk-weights for each current consumer loan type reported on the Call Report.

TABLE 12—PROPOSED RISK-WEIGHTS FOR CONSUMER LOAN TYPES REPORTED ON CALL REPORT

Consumer loan type—Less than 60 days delinquent	Proposed risk-weight (percent)
Unsecured Credit Card Loan	75
All Other Unsecured Loans/Lines of Credit	75
Short-Term, Small Amount Loans	75
Federally Guaranteed Student Loans	0
Non-Federally Guaranteed Student Loans	100
New Vehicle Loans	75
Used Vehicle Loans	75
Leased Receivable	75
All Other Loans/Lines of Credit	75

Delinquent consumer loans. The current risk-based capital measure does not contain a higher risk-weight for delinquent consumer loans. Rising levels of delinquent loans are an indicator of increased risk. To reflect the impaired credit quality of past due loans, the proposal would require credit unions to assign a 150 percent risk-weight to a non-real estate loan if it is 60 days or more past due or in nonaccrual status. NCUA realizes that the ALLL is already reflected in the risk-based capital numerator and increased provision expenses decrease retained earnings. However, the ALLL is intended to cover estimated, incurred losses as of the balance sheet date, rather than unexpected losses. The higher risk-weight on past due exposures ensures sufficient regulatory capital for the increased probability of unexpected losses on these exposures. The higher risk-weights better capture the risk associated with the impaired credit quality of these exposures.

TABLE 13—PROPOSED RISK-WEIGHTS FOR DELINQUENT CONSUMER LOANS

Consumer loan type—Delinquent more than 60 days	Proposed risk-weight (percent)
Unsecured Credit Card Loan	150
All Other Unsecured Loans/Lines of Credit	150
Short-Term, Small Amount Loans	150
Non-Federally Guaranteed Student Loans	150
New Vehicle Loans	150
Used Vehicle Loans	150
Leased Receivable	150
All Other Loans/Lines of Credit	150

Loans to CUSOs and CUSO investments. Since Call Reports are prepared on a consolidated basis, wholly owned or majority owned CUSO assets are consolidated with the credit union's books and records with applicable risk-weights assigned by the asset type. The current risk-based measure assigns the risk-weight for average-risk assets to the amount of the credit union's investments in CUSOs and loans to CUSOs, as reported in the Other Asset Call Report item. The proposal would increase the risk-weight to 250 percent for investments in CUSOs. This increase is due to the risk of this unsecured equity investment, which is almost always in a non-publicly traded entity. Loans to CUSOs are normally a higher payout priority in the event of liquidation of a CUSO, and thus would be assigned a risk-weight of 100 percent.

TABLE 14—PROPOSED RISK-WEIGHTS FOR LOANS TO CUSOS & INVESTMENTS IN CUSOS

	Proposed risk-weight (percent)
Loans to CUSO	100
Investment in CUSO	250

Mortgage servicing asset (MSA). The proposal would address the complexity and variability of the risks, including interest rate risk and market risk, associated with a MSA by assigning a 250 percent risk-weight. MSAs can become impaired when interest rates fall and borrowers refinance or prepay their mortgage loans. This impairment

[55] The risk-weightings were converted to a comparable risk-weight by dividing the current risk-weighting by 8 percent, representing the level of risk-weighted capital need to be adequately capitalized. In the current rule, long-term real estate loans less than the 25 percent threshold receive a 6 percent risk-weighting, which is equivalent to a 75 percent risk weight under this proposal (6% divided by 8%). Total long-term real estate loans over the 25 percent threshold receive a 14 percent risk-weighting, which is equivalent to a 175 percent risk weight under this proposal (14% divided by 8%).

[56] Analysis of call report data indicates that the proposed risk weights produce an aggregate minimum capital requirement, at the well capitalized level, of 97 percent of the current minimum RBNW requirement for real estate loans when applied to affected credit unions.

[57] This is consistent with the Other Federal Banking Regulatory Agencies' capital rules (e.g., 12 CFR 324.32), which maintained the 100 percent risk-weight for non-delinquent consumer loans. *See, e.g.,* 78 FR 55339 (Sept. 10, 2013).

[58] Up until 2010, guaranteed student loans were available through private lending institutions under the Federal Family Education Loan Program (FFELP). Those loans were funded by the Federal government, and administered by approved private lending organizations. In effect, these loans were underwritten and guaranteed by the Federal government, ensuring that the private lender would assume no risk should the borrower ultimately default. Loans issued under this program prior to June 30, 2012 will remain on the books of credit unions for many years.

TABLE 6—RISK-WEIGHT CATEGORIES AND ASSOCIATED RISK-WEIGHTS—Continued

Risk-weight category	Risk-weight	Items included
		• Loans guaranteed 75 percent or more by the SBA, U.S. Department of Agriculture, or other U.S. Government agency.
Category 3	50 percent	• The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years. • The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.
Category 4	75 percent	• The total amount of investments with a weighted-average life of greater than three years, but less than or equal to five years. • Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans (STS), new vehicle loans, used vehicle loans, leases receivable and all other loans; (Excluding loans reported as MBLs). • Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.
Category 5	100 percent	• Corporate credit union nonperpetual capital. • The total outstanding principal amount loaned to CUSOs. • Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets. • Delinquent first mortgage real estate loans. • Other real estate-secured loans less than or equal to 10 percent of assets. • MBLs less than or equal to 15 percent of assets. • Loans held for sale. • The total amount of any foreclosures and repossessed assets. • Land and building, less depreciation on building. • Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation. • Current non-federally insured student loans. • All other assets not specifically assigned a risk-weight but included in the balance sheet.
Category 6	125 percent	• Total amount of all other real estate-secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets.
Category 7	150 percent	• The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years. • Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding loans reported as MBLs). • The total amount of all other real estate-secured loans greater than 20 percent of assets. • Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets.
Category 8	200 percent	• Corporate credit union perpetual capital. • The total amount of investments with a weighted-average life of greater than 10 years. • The total amount of MBLs greater than 25 percent of assets, other than MBLs included in Category 9 above.
Category 9	250 percent	• The total value of investments in CUSOs. • The total value of mortgage servicing assets.
Category 10	1,250 percent	• An asset-backed investment for which the credit union is unable to demonstrate, as required under §702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance.

A further explanation of risk-weights based on balance sheet asset type follows.

Cash and investment risk-weights. The proposal generally would maintain the existing structure for measuring risk-weights for most cash items and investments. For specific investments, the risk-weights would continue to be based upon the "weighted-average life of investments" (WAL), as defined within the regulation. The WAL is generally the average time until a dollar of principal is repaid.

TABLE 7—PROPOSED RISK-WEIGHTS FOR CASH AND INVESTMENTS

Item	Proposed risk-weight (percent)
Cash on hand	0
NCUA and FDIC Issued Guaranteed Notes	0
Direct, unconditional U.S. Government obligations	0
Cash on deposit	20
Cash equivalents	20
Total investments with WAL ≤ 1-year	20
Total investments with WAL >1-year and ≤ 3-years	50
Total investments with WAL >3-year and ≤ 5-years	75
Corporate credit union nonperpetual capital	100
Total investments with WAL >5-year and ≤ 10-years	150
Total investments with WAL > 10-years	200

loans; leases receivable; and all other loans (excluding loans reported as MBLs).

- The total amount of all other real estate-secured loans greater than 20 percent of assets.
- Any MBLs greater than 15 percent of assets and less than or equal to 25 percent of assets.

104(c)(2)(viii) Category 8—200 Percent Risk-Weight

Proposed § 702.104(c)(2)(viii) would require that credit unions assign a 200 percent risk-weight to the following on-balance sheet assets:

- Corporate credit union perpetual capital.
- The total amount of investments with a weighted-average life of greater than 10 years.
- The total amount of MBLs greater than 25 percent of assets, other than MBLs included in Category 3 above.

104(c)(2)(ix) Category 9—250 Percent Risk-Weight

Proposed § 702.104(c)(2)(ix) would require that credit unions assign a 250 percent risk-weight to the following on-balance sheet assets:

- The total value of investments in CUSOs.
- The total value of MSAs.

104(c)(2)(x) Category 10—1,250 Percent Risk-Weight

Proposed § 702.104(c)(2)(x) would require that credit unions assign a 1,250 percent risk-weight (8% * 1,250% = 100%) to an asset-backed investment for which the credit union is unable to demonstrate, as required under § 702.104(d), a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance. A 1,250 percent risk-weight is equivalent to holding capital equal to 100 percent of the investment's balance sheet value.[60]

During the recent financial crisis, it became apparent that many federally insured financial institutions relied exclusively on ratings issued by Nationally Recognized Statistical Organizations (NRSOs) and did not perform internal credit analysis of asset-backed investments. Complex credit unions must be able to demonstrate a comprehensive understanding of any investment, particularly an understanding of the features of an asset-backed investment that would materially affect its performance. Upon purchase and on an ongoing basis, the credit union must evaluate, review, and update as appropriate the analysis performed on an asset-backed investment. In the event a credit union is unable to demonstrate a comprehensive understanding of an asset-backed investment, the proposed rule would provide for assigning a risk-weight of 1,250 percent to that investment.

104(c)(3) Risk-Weights for Off-Balance Sheet Activities

Proposed § 702.104(b)(3) would provide that the risk-weighted amounts for all off-balance sheet items are determined by multiplying the notional principal, or face value, by the appropriate conversion factor and the assigned risk-weight as follows:

- A 75 percent conversion factor with a 100 percent risk-weight for unfunded commitments for MBLs.
- A 75 percent conversion factor with a 100 percent risk-weight for MBLs transferred with limited recourse.
- A 75 percent conversion factor with a 50 percent risk-weight for first mortgage real estate loans transferred with limited recourse.
- A 75 percent conversion factor with a 100 percent risk-weight for other real estate loans transferred with limited recourse.
- A 75 percent conversion factor with a 100 percent risk-weight for non-federally guaranteed student loans transferred with limited recourse.
- A 75 percent conversion factor with a 75 percent risk-weight for all other loans transferred with limited recourse.
- A 10 percent conversion factor with a 75 percent risk-weight for total unfunded commitments for non-business loans.

The risk-based capital measure in current § 702.104 includes the amount of commitments outstanding for loans sold with recourse and unused member business loan commitments in the calculation of risk-assets. The current rule recognizes the potential for these commitments to quickly become on-balance sheet assets with their related risks.

Under this proposal, a credit union would calculate the exposure amount of an off-balance sheet component, which is usually the contractual amount multiplied by the applicable credit conversion factor (CCF). This treatment would apply to specific off-balance sheet items, including loans sold with recourse, unfunded commitments for business loans, and other unfunded commitments. The proposed rule would improve risk sensitivity and implement capital requirements for certain exposures through a simple methodology.

Large draws on unused MBL commitments may cause liquidity problems and heighten exposure to credit risk. MBL commitments typically do not feature a "material adverse conditions" clause as grounds for revocation. The proposed rule would assign a 75 percent CCF and a 100 percent risk-weight to unused member business loan commitments.

The proposal would retain the existing assumption that the risk exposure associated with recourse loans is analogous to that associated with similar on-balance sheet loans. The proposal would reduce the existing capital requirement for first mortgage real estate loans and consumer loans by assigning them a 75 percent CCF and a risk-weight consistent with the risk-weight assigned for the loan type for on-balance sheet loans.

TABLE 17—PROPOSED CREDIT CONVERSION FACTORS AND RISK-WEIGHTS FOR OFF-BALANCE SHEET ASSETS

	Proposed CCF (percent)	Proposed risk-weight (percent)
Unused MBL commitments	75	100
MBLs sold with recourse	75	100
First mortgage real estate loans sold with recourse	75	50
Other real estate loans sold with recourse	75	100
Non-federally guaranteed student loans sold with recourse	75	100
All other loans sold with recourse	75	75

[60] 8 percent adequately capitalized level * 1,250 percent = 100 percent.

This proposal would add a relatively small capital requirement for the total reported unfunded commitments for non-MBL. The proposal would apply a CCF of 10 percent with a 75 percent risk-weight. NCUA included this commitment with a relatively small capital requirement in order to recognize the risk that a credit union with a substantial amount of unfunded loan commitments may unexpectedly be required to fund such obligations, creating a drain on liquidity and a shifting of assets which could cause a significant increase in the minimum capital requirement.

TABLE 18—PROPOSED CREDIT CONVERSION FACTOR AND RISK-WEIGHT FOR TOTAL UNFUNDED COMMITMENTS FOR NON-BUSINESS LOANS

	CCF (percent)	Proposed risk-weight (percent)
Total unfunded commitments for non-business loans	10	75

The proposed rule would expressly exclude loans sold to the secondary mortgage market that feature representations and warranties customarily required by the U.S. Government (e.g., Ginnie Mae) and government-sponsored enterprises (e.g., Fannie Mae and Freddie Mac). These include representations that the credit union has underwritten the loan and appraised the collateral in conformity with identified standards. These representations provide for the return of assets to the originating credit union in instances of incomplete documentation or fraud. Such representations would be exempt provided the history of payment on these representations is infrequent. Credit enhancing representations and warranties beyond the usual agency requirements would be considered recourse and thus would not be excluded from this risk portfolio.

104(c)(4) Derivatives

Proposed § 702.104(c)(4) would adopt an approach to assign risk-weights to derivatives that is generally consistent with the approach adopted by the FDIC in its recently issued interim final rule regarding regulatory capital.[61]

Under the FDIC's interim rule, derivatives transactions covered under clearing arrangements are treated differently than non-cleared transactions. The NCUA Board is proposing a single regulatory capital approach regardless of the credit union's derivatives transaction clearing status. This selection of regulatory capital treatment is not intended to express a position on credit union clearing. This approach was selected because most credit unions have less than $10 billion in total assets and are exempt from the Commodity Futures Trading Commission's (CFTC) clearing requirements.[62] Credit unions with more than $10 billiou in total assets would fall under the CFTC's recently issued final rule regarding clearing exemption for certain swaps entered into by cooperatives.[63]

Derivatives transaction risk-weighting. To determine the risk-weighted asset amount for a derivatives contract under the proposed rule, a credit union would first determine its exposure amount for the contract. It would then apply to that amount a risk-weight based on the counterparty or recognized collateral. For a single derivatives contract that is not subject to a qualifying master netting agreement (as defined further below in this section), the proposed rule would require the exposure amount to be the sum of (1) the credit union's current credit exposure (CCE), which is the greater of the fair value or zero, and (2) potential future exposure (PFE), which is calculated by multiplying the notional principal amount of the derivatives contract by the appropriate conversion factor, in accordance with Table 19 below.

TABLE 19—PROPOSED CONVERSION FACTOR MATRIX FOR DERIVATIVES CONTRACTS

Remaining maturity	Interest rate risk hedge derivatives	All other derivatives[64]
One year or less	0.00	0.10
Greater than one year and less than or equal to five years	0.005	0.12
Greater than five years	0.015	0.15

For multiple derivatives contracts subject to a qualifying master netting agreement, a credit union would calculate the exposure amount by adding the net CCE and the adjusted sum of the PFE amounts for all derivatives contracts subject to that qualifying master netting agreement.

The net CCE is the greater of zero and the net sum of all positive and negative fair values of the individual derivatives contracts subject to the qualifying master netting agreement. The adjusted sum of the PFE amounts would be calculated as described in § 702.104(c)(4)(*ii*)(B) of the proposed rule.

To recognize the netting benefit of multiple derivatives contracts, the contracts would have to be subject to the same qualifying master netting agreement. For example, a credit union with multiple derivatives contracts with a single counterparty could add the counterparty exposure if the transactions fall under an International Swaps and Derivatives Association, Inc. (ISDA) Master Agreement and Schedule.

If a derivatives contract is collateralized by financial collateral, a credit union would first determine the exposure amount of the derivatives contract as described in § 702.14(c)(4)(i). Next, to recognize the credit risk mitigation benefits of the financial collateral, the credit union would use

[61] *See* 78 FR 55339 (Sept. 10, 2013).

[62] 17 CFR part 50.

[63] 78 FR 52265 (Aug. 22, 2013); *see also* 17 CFR 50.51.

[64] This would include all other derivatives contracts including foreign exchange, equity, credit, and commodity.

the approach for collateralized transactions as described in § 702.104(c)(4)(v)(B) of the proposed rule.

Collateralized transactions. Under the proposed rule, NCUA would permit a credit union to recognize risk-mitigating effects of financial collateral. The collateralized portion of the exposure receives the risk-weight applicable to the collateral. In all cases, (1) the collateral must be subject to a collateral agreement (for example, an ISDA Credit Support Annex) for at least the life of the exposure; (2) the credit union must revalue the collateral at least every three months; and (3) the collateral and the exposure must be denominated in U.S. dollars.

Generally, the risk-weight assigned to the collateralized portion of the exposure would be no less than 20 percent. However, the collateralized portion of an exposure may be assigned a risk-weight of less than 20 percent for the following exposures. Derivatives contracts that are marked to fair value on a daily basis and subject to a daily margin maintenance agreement could receive (1) a zero percent risk-weight to the extent that contracts are collateralized by cash on deposit, or (2) a 10 percent risk-weight to the extent that the contracts are collateralized by an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(i) of the proposed rule. In addition, a credit union could assign a zero percent risk-weight to the collateralized portion of an exposure where the financial collateral is cash on deposit. It also could do so if the financial collateral is an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(i) of the proposed rule, and the credit union has discounted the fair value of the collateral by 20 percent. The credit union would be required to use the same approach for similar exposures or transactions.

Risk management guidance for recognizing collateral. Before a credit union recognizes collateral for credit risk mitigation purposes, it should: (1) Conduct sufficient legal review to ensure, at the inception of the collateralized transaction and on an ongoing basis, that all documentation used in the transaction is binding on all parties and legally enforceable in all relevant jurisdictions; (2) consider the correlation between risk of the underlying direct exposure and collateral in the transaction; and (3) fully take into account the time and cost needed to realize the liquidation proceeds and the potential for a decline in collateral value over this time period.

A credit union should also ensure that the legal mechanism under which the collateral is pledged or transferred ensures that the credit union has the right to liquidate or take legal possession of the collateral in a timely manner in the event of the default, insolvency, or bankruptcy (or other defined credit event) of the counterparty and, where applicable, the custodian holding the collateral.

In addition, a credit union should ensure that it (1) has taken all steps necessary to fulfill any legal requirements to secure its interest in the collateral so that it has, and maintains, an enforceable security interest; (2) has set up clear and robust procedures to ensure satisfaction of any legal conditions required for declaring the borrower's default and prompt liquidation of the collateral in the event of default; (3) has established procedures and practices for conservatively estimating, on a regular ongoing basis, the fair value of the collateral, taking into account factors that could affect that value (for example, the liquidity of the market for the collateral and deterioration of the collateral); and (4) has in place systems for promptly requesting and receiving additional collateral for transactions whose terms require maintenance of collateral values at specified thresholds.

104(d) Due Diligence Requirements for Asset-Backed Investments

Proposed § 702.104(d) would contain due diligence requirements credit unions would have to implement in demonstrating a comprehensive understanding of the features of an asset-backed investment. The NCUSIF has experienced significant losses by credit unions that invested heavily in asset-backed investments without the board of directors or staff having sufficient expertise to understand and manage the risks. The proposed rule defines the general content of an adequate analysis and the timing of the analysis.

(d)(1)

Proposed § 702.104(d)(1) would provide that if a credit union is unable to demonstrate a comprehensive understanding, as required under proposed § 702.104(d)(2), of the features of an asset-backed investment exposure that would materially affect the performance of the exposure, the credit union must assign a 1,250 percent risk-weight to the asset-backed investment exposure. The proposed rule would also require that the credit union's analysis be commensurate with the complexity of the asset-backed investment and the materiality of the position in relation to regulatory capital according to this part.

(d)(2)

Proposed § 702.104(d)(2) would provide that a credit union must demonstrate its comprehensive understanding of each asset-backed investment exposure under § 702.104(d)(1) by:

- Conducting an analysis of the risk characteristics of an investment's exposure prior to acquiring the investment and documenting such analysis within three business days after acquiring the exposure, considering:
  - Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;
  - Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);
  - Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and
  - For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and
- On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under this section for each investment exposure.

Current Section 702.105 Weighted-Average Life of Investments

As discussed above in the definitions part of the section-by-section analysis, proposed § 702.105 would replace current § 702.105 regarding weighted-average life of investments, and the definition in the current section would be moved to the definition of "weighted-average life of investments" in proposed § 702.2.

Section 702.105 Individual Minimum Capital Requirements

Capital helps ensure individual credit unions can continue to serve as credit intermediaries even during times of stress, thereby promoting the safety and soundness of the U.S. credit union system. As with the current Part 702, the proposed capital rules would be minimum standards generally based on broad credit risk and concentration considerations.

A complex credit union is generally expected to have internal processes for assessing capital adequacy that reflects a full understanding of its risk exposure and to ensure that it holds capital corresponding to those risks. The nature of such capital adequacy assessments should be commensurate with the credit union's size, complexity, and risk profile. Supervisory assessment of capital adequacy will take into account whether a credit union plans appropriately to maintain an adequate level of capital given its activities and risk profile, as well as risks and other factors that can affect a credit union's financial condition. The supervisory assessment will also consider the potential impact on earnings and the capital base from prospective economic conditions. For this reason, a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of a credit union's regulatory capital ratios.

In light of these considerations, as a prudent matter, a complex credit union is generally expected to operate with capital positions above the minimum risk-based capital measures and hold capital commensurate with the level and nature of the risk to which it is exposed. Credit unions contemplating significant expansion proposals are expected to maintain strong capital levels above the minimum ratios and should not allow significant diminution of financial strength below those strong levels to fund their expansion plans. Complex credit unions with high levels of risk are also expected to operate with capital well above minimum risk-based standards.

This proposed rule includes a provision that NCUA may require a higher minimum risk-based capital ratio for an individual credit union in any case where the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. For example, higher capital may be appropriate for a credit union that has significant exposure to declines in the economic value of its capital due to changes in interest rates. Part 747 would contain procedures for requiring a credit union to maintain a higher minimum capital.

105(a) General

Proposed § 702.105(a) would provide that the rules and procedures specified in this paragraph apply to the establishment of an individual minimum capital requirement for a credit union that varies from any of the risk-based capital requirement(s) that would otherwise apply to the credit union under this part.

105(b) Appropriate Considerations for Establishing Individual Minimum Capital Requirements

Proposed § 702.105(b) would provide that minimum capital levels higher than the risk-based capital requirements under this part may be appropriate for individual credit unions. NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is or may become inadequate in view of the credit union's circumstances. In addition, the proposed rule provides the following situations in which NCUA may find that higher capital levels are appropriate:

• A credit union is receiving special supervisory attention.
• A credit union has or is expected to have losses resulting in capital inadequacy.
• A credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk.
• A credit union has poor liquidity or cash flow.
• A credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not adequately addressed by other NCUA regulations or other guidance.
• A credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit.
• A credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or which has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms.
• A credit union has inadequate underwriting policies, standards, or procedures for its loans and investments.
• A credit union has failed to properly plan for, or execute, necessary retained earnings growth.
• A credit union has a record of operational losses that exceeds the average of other similarly situated credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

105(c) Standards for Determination of Appropriate Individual Minimum Capital Requirements

Proposed § 702.105(c) would provide that the appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria, and that the decision is necessarily based, in part, on a subjective judgment grounded in agency expertise. The proposed rule provides the following additional factors that may be considered by NCUA in making its determination:

• The conditions or circumstances leading to the determination that a higher minimum capital requirement is appropriate or necessary for the credit union.
• The urgency of those circumstances or potential problems.
• The overall condition, management strength, and future prospects of the credit union and, if applicable, its subsidiaries, affiliates, and business partners.
• The credit union's liquidity, capital, and other indicators of financial stability, particularly as compared with those of similarly situated credit unions.
• The policies and practices of the credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices.

Current Section 702.106 Standard Calculation of Risk-Based Net Worth Requirement

The proposed rule would eliminate current § 702.106 regarding the standard RBNW requirement. The current rule is structured so that credit unions have a standard measure and optional alternatives for measuring a credit union's RBNW. The proposed rule, on the other hand, would contain only a single measurement for calculating a credit union's risk-based capital ratio.

Accordingly, current § 702.106 would no longer be necessary and has been eliminated from the proposed rule.

Current Section 702.107 Alternative Component for Standard Calculation

The proposed rule would eliminate current § 702.107 regarding the use of alternative risk-weight measures. NCUA believes the current alternative risk-weight measures add unnecessary complexity to the rule. The current alternative risk-weights focus almost exclusively on interest rate risk, which has resulted in some credit unions with higher risk operations reducing their regulatory minimum capital requirement to a level inconsistent with the risk of the credit union's business model. The proposed risk-weights would provide for lower risk-based capital requirements for those credit unions making good quality loans, investing prudently, and avoiding concentrations of assets.

Current Section 702.108 Risk Mitigation Credit

This proposed rule would eliminate § 702.108 regarding the risk mitigation credit. The risk mitigation credit provides a system for reducing a credit union's risk-based capital requirement if it can demonstrate significant mitigation of credit or interest rate risk. Credit unions have rarely taken advantage of risk mitigation credits, with only one credit union receiving a risk mitigation credit. The review of a credit union's application for a risk mitigation credit requires a substantial commitment of NCUA and credit union resources. In practice, it is very difficult to determine the validity of the credit union's mitigation efforts and how much mitigation credit to allow.

Mandatory and Discretionary Supervisory Actions

Section 216(a)(2) of the FCUA directs NCUA to take prompt corrective actions to resolve the problems of insured credit unions.[65] To facilitate this purpose, the FCUA defined five regulatory capital categories that include capital thresholds for a defined net worth ratio and risk-based capital measure for "complex" credit unions. These five PCA categories are: Well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Credit unions that fail to meet those capital measures are subject to increasingly strict limits on their activities.[66]

The proposal would generally maintain the existing mandatory and discretionary supervisory actions (PCA actions) currently contained in §§ 702.201 through 702.204.[67] The PCA actions aid in accomplishing the PCA's purpose and provide a transparent guide of supervisory actions that a credit union can expect as capital measures decline.

Section 702.106 Prompt Corrective Action for Adequately Capitalized Credit Unions

The proposed rule would renumber current § 702.201 as proposed § 702.106, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.106(a) would be amended to remove the requirement that adequately capitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.107 Prompt Corrective Action for Undercapitalized Credit Unions

The proposed rule would renumber current § 702.202 as proposed § 702.107, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.107(a)(1) would be amended to remove the requirement that undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.108 Prompt Corrective Action for Significantly Undercapitalized Credit Unions

The proposed rule would renumber current § 702.203 as proposed § 702.108, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.108(a)(1) would be amended to remove the requirement that significantly undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.109 Prompt Corrective Action for Critically Undercapitalized Credit Unions

The proposed rule would renumber current § 702.204 as proposed § 702.109, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.109(a)(1) would be amended to remove the requirement that critically undercapitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.110 Consultation With State Official on Proposed Prompt Corrective Action

The proposed rule would renumber current § 702.205 as proposed § 702.110, and would make only minor conforming amendments to the text of the section.

Section 702.111 Net Worth Restoration Plans (NWRPs)

The proposed rule would renumber current § 702.206 as proposed § 702.111, and would make only minor conforming amendments to the text of most of the subsections, with a few exceptions discussed in more detail below.

111(c) Contents of NWRP

Proposed § 702.111(c)(1)(i) would provide that the contents of an NWRP must specify a quarterly timetable of steps the credit union will take to increase its net worth ratio *and risk-based capital ratio, if applicable*, so that it becomes adequately capitalized by the end of the term of the NWRP, and will remain so for four (4) consecutive calendar quarters; and that if complex, the credit union is subject to a RBNW requirement that may require a net worth ratio higher than 6 percent to become adequately capitalized. The proposed rule would add the italicized words "and risk-based capital ratio, if applicable" above to clarify that an NWRP prepared by a complex credit union must specify the steps the credit union will take to increase its risk-based capital ratio.

In addition, consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.111(c)(1)(ii) would be amended to remove the requirement that credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

[65] 12 U.S.C. 1790d(a)(2).

[66] Credit union defined as "new credit unions" under section 1790(d)(2) of the FCUA are subject to an alternative PCA system.

[67] The requirements would be moved to proposed §§ 702.106 through 702.109.

111(g) NWRP Not Approved

111(g)(4) Submission of Multiple Unapproved NWRPs

Proposed § 702.111(g)(4) would provide that the submission of more than two NWRPs that are not approved is considered an unsafe and unsound condition and may subject the credit union to administrative enforcement actions under section 206 of the FCUA.[68] NCUA regional directors have expressed concerns that some credit unions have in the past submitted multiple NWRPs that could not be approved due to non-compliance with the requirements of the current rule, resulting in delayed implementation of actions to improve the credit union's net worth. The proposed amendments are intended to clarify that submitting multiple NWRPs that are rejected by NCUA, or the applicable state official, because of the inability of the credit union to produce an acceptable NWRP is an unsafe and unsound practice and may subject the credit union to further actions as permitted under the FCUA.

111(j) Termination of NWRP

Proposed § 702.111(j) would provide that, for purposes of part 702, an NWRP terminates once the credit union has been classified as adequately capitalized or well capitalized and for four consecutive quarters. The proposed paragraph would also provide as an example that if a credit union with an active NWRP attains the classification as adequately capitalized on December 31, 2015, this would be quarter one and the fourth consecutive quarter would end September 30, 2016. The proposed paragraph is intended to provide clarification for credit unions on the timing of an NWRP's termination.

Section 702.112 Reserves

The proposed rule would renumber current § 702.401 as proposed § 702.112. Consistent with the text of current § 702.401(a), it also would require that each credit union establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or, in special cases, by the NCUA Board or appropriate state official.

Regular reserve account. As mentioned above, the proposed rule would eliminate current § 702.401(b) regarding the regular reserve account from the earnings retention process. Additionally, the process and substance of requesting permission for charges to the regular reserve would be eliminated upon the effective date of a final rule. Upon the effective date of a final rule, federal credit unions would close out the regular reserve balance into undivided earnings. A state-chartered, federally insured credit union may still be required to maintain a regular reserve account by its respective state supervisory authority.

The Board initially included the regular reserve in part 702 for purposes of continuity from past regulatory expectations that involved this account to ease credit unions' transition to the then new PCA rules. The regular reserve account is not necessary to satisfying the statutory "earnings retention requirement" and is not required under GAAP. CUMAA requires credit unions that are not well capitalized to "annually set aside as net worth an amount equal to not less than 0.4 percent of its total assets."[69] The earnings retention requirement in current § 702.201(a) requires a credit union that is not well capitalized to increase the "dollar amount of its net worth either in the current quarter, or on average over the current and three preceding quarters by an amount equivalent to at least 1/10th percent of total assets." Under the current rule, the credit union must then "quarterly transfer that amount" from undivided earnings to the regular reserve account. Increasing net worth alone satisfies the statutory earnings retention requirement. The additional step of transferring earnings from the undivided earnings account to the regular reserve account is not necessary to meet the PCA statutory requirement.

The regular reserve was initially incorporated into the earnings retention process because of familiarity. Prior to PCA, credit unions used the regular reserve account under the former reserving process prescribed by the now repealed section 116 of the FCUA.[70] However, examiner experience indicates that since PCA was first implemented, the regular reserve account in part 702 has been a source of unnecessary confusion. Some credit unions have continued to make transfers as if the repealed section 116 were still in force. Other credit unions have confused the purpose of the regular reserve in the current PCA process. Thus, some credit unions have made earnings transfers that are not required and others have done so without first increasing net worth.

For these reasons, the Board now considers the regular reserve account to be obsolete and proposes its elimination upon the effective date of a final rule. The proposed rule eliminates the cross references to the regular reserve requirement as discussed in more detail in each corresponding part of the section-by-section analysis.

Section 702.113 Full and Fair Disclosure of Financial Condition

The proposed rule would renumber current § 702.402 as proposed § 702.113, and would make only minor conforming amendments to the text of the section with one exception, which is discussed in more detail below.

113(d) Charges for Loan Losses

Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.113(d) would be amended to remove paragraph (d)(4) of the current rule, which provided that the maintenance of an ALLL shall not affect the requirement to transfer earnings to a credit union's regular reserve when required under subparts B or C of this part.

Section 702.114 Payment of Dividends

The proposed rule would renumber current § 702.402 as proposed § 702.114 and make a number of amendments to the text of subsections (a) and (b), and add new subsection (c).

114(a) Restriction on Dividends

Current § 702.402(a) permits credit unions with a depleted undivided earnings balance to pay dividends out of the regular reserve account without regulatory approval, as long as the credit union will remain at least adequately capitalized. Proposed § 702.114(a), however, would allow only credit unions that have substantial net worth, but no undivided earnings, to pay dividends without regulatory approval.

114(b) Payment of Dividends if Retained Earnings Depleted

Proposed § 702.114(b) would provide that well capitalized credit unions could pay dividends only if their net worth classification do not fall below adequately capitalized. As with the current § 702.402(b)(2), proposed § 702.114(b)(2) would require approval from the appropriate Regional Director, and if state-chartered, the appropriate state official, if after payment of the dividend the credit union's net worth classification would fall below adequately capitalized. In addition, the proposed rule would require that the credit union's request for written approval include the credit union's plan for eliminating any negative retained earnings balance. Secondary capital accounts would continue to be excluded

[68] 12 U.S.C. 1786 and 1790d.

[69] 12 U.S.C. 1790d(e)(1).

[70] 12 U.S.C. 1762.

as a direct source of dividend payments. Dividends would not be considered operating losses and could not be paid out of secondary capital.

114(c) Restriction on Payments of Dividends if, After Payment of Dividends, the Credit Union's Net Worth Ratio Would Be Less Than 6 Percent

Proposed § 702.114(c) would prohibit a credit union from unreasonably dissipating its capital through excessive dividend payments or a refund of interest in a manner that would undermine the safety and soundness of the credit union. In particular, the proposed rule would prohibit a credit union currently classified as well capitalized from paying dividend rates that are higher than the prevailing market rates, declaring a non-repetitive dividend, or approving a refund of interest if, after the payment of the dividend, the credit union's net worth ratio would decline to less than 6 percent in the current quarter. This new provision would prevent the unsafe dissipation of capital through the payment of special or bonus dividends or interest refunds while still allowing for continuity of operations.

B. Subpart B—Alternative Prompt Corrective Action for New Credit Unions

The proposed rule would add new subpart B, which would contain most of the capital adequacy rules that would apply to "new" credit unions. Section 216(b)(2)(B)(iii) of the FCUA defines a "new" credit union as one that has been in operation for 10 years or less, or has $10 million or less in total assets.[71]

The current net worth measures, net worth classification, and text of the PCA requirements applicable to new credit unions would be renumbered. They would remain mostly unchanged in the proposed rule, however, except for the following substantive amendments:

(1) Elimination of the regular reserve account requirement in current § 702.401(b) and all cross references to the requirement;

(2) Addition of new § 701.206(f)(3) clarifying that the submission of more than two revised business plans would be considered and unsafe and unsound condition; and

(3) Amendment of the requirements of current § 702.403 regarding the payment of dividends.

Each of these substantive amendments is discussed in more detail below.

[71] 12 U.S.C. 1790d(b)(2)(B)(iii).

Section 702.201 Scope and Definition

The proposed rule would renumber current § 702.301 as proposed § 702.201. The proposed rule would eliminate the ability of a credit union to regain a designation of new after reporting total assets in excess of $10 million.

Section 216(b)(2) of the FCUA requires the NCUA to prepare regulations that apply to new credit unions. The FCUA further requires that rules for new credit unions prevent evasion of the purpose of section 216, which provides new credit unions a period of time to accumulate net worth. NCUA recently conducted a postmortem review of a credit union failure that caused a loss to the NCUSIF. The review revealed that the credit union intentionally reduced its total assets below $10 million to regain the designation "new" credit union under current part 702 and the associated lower net worth requirement. Shifting back and forth between the minimum capital requirement for "new" and all other credit unions resulted in slowed capital accumulation, which contributed to the loss incurred by the NCUSIF. Accordingly, NCUA is now proposing to amend the definition of "new" credit union in current § 702.301 to eliminate such practices in the future.

In general, credit unions attaining an asset size of $10 million begin to offer a greater range of services and loans, which increase the credit union's complexity and risk to the NCUSIF. In the event a new credit union reports total assets of over $10 million and then subsequently declines to under $10 million, the additional PCA regulatory requirements under the proposed rule would not be substantially increased. Both new credit unions and non-new credit unions with net worth ratios of less than 6 percent, but over 2 percent, are required under either § 702.206 or § 702.111 of the proposal to operate under substantially similar plans to restore their net worth. For example, a new credit union with a net worth ratio of 5 percent is required to operate under a revised business plan, and a non-new credit union with a net worth ratio of 5 percent is required to operate under a NWRP. Therefore, any burden associated with this change to the requirements of part 702 should be minimal.

Section 702.202 Net Worth Categories for New Credit Unions

The proposed rule would renumber current § 702.302 as proposed § 702.202, and would make only minor conforming amendments to the text of the section.

Section 702.203 Prompt Corrective Action for Adequately Capitalized New Credit Unions

The proposed rule would renumber current § 702.303 as proposed § 702.203, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), proposed § 702.203 would be amended to remove the requirement that adequately capitalized credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.204 Prompt Corrective Action for Moderately Capitalized, Marginally Capitalized or Minimally Capitalized New Credit Unions

The proposed rule would renumber current § 702.304 as proposed § 702.204, and would make only minor conforming amendments to the text of the section. Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), which is discussed in more detail below, proposed § 702.204(a)(1) would be amended to remove the requirement that such credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

Section 702.205 Prompt Corrective Action for Uncapitalized New Credit Unions

The proposed rule would renumber current § 702.305 as proposed § 702.205, and would make only minor conforming amendments to the text of the section.

Section 702.206 Revised Business Plans (RBP) for New Credit Unions

The proposed rule would renumber current § 702.306 as proposed § 702.206, would make mostly minor conforming amendments to the text of the section, and would add new § 702.206(g)(3). Consistent with the proposed elimination of the regular reserve requirement in current § 702.401(b), which is discussed in more detail below, proposed § 702.206(b)(3) would be amended to remove the requirement that new credit unions transfer the earnings retention amount from undivided earnings to their regular reserve account.

206(g)(3) Submission of Multiple Unapproved Revised Business Plans

Proposed § 702.206(g)(3) would provide that the submission of more than two RBPs that are not approved is considered an unsafe and unsound condition and may subject the credit union to administrative enforcement actions under section 206 of the FCUA.[72] NCUA regional directors have expressed concerns that some credit unions have in the past submitted multiple RBPs that could not be approved due to non-compliance with the requirements of the current rule, resulting in delayed implementation of actions to improve the credit union's net worth. The proposed amendments are intended clarify that submitting multiple RBPs that are rejected by NCUA, or the state official, because of the failure of the credit union to produce an acceptable RBP is an unsafe and unsound practice and may subject the credit union to further actions as permitted under the FCUA.

Section 702.207 Incentives for New Credit Unions

The proposed rule would renumber current § 702.307 as proposed § 702.207, and would make only minor conforming amendments to the text of the section.

Section 702.208 Reserves

The proposed rule would add new § 702.208 regarding reserves for new credit unions to the rule and, consistent with the text of current reserve requirement at § 702.401(a), would require that each new credit union establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate state official.

As explained under § 702.112, the proposed rule would eliminate the regular reserve account under current § 702.402(b) from the earnings retention requirement. Additionally the process and substance of requesting permission for charges to the regular reserve would be eliminated upon the effective date of a final rule. Upon the effective date of a final rule federal credit unions would close out the regular reserve balance into undivided earnings. A federally insured state chartered credit union may still be required to maintain a regular reserve account as dictated by state law or by its respective state supervisory authority.

Section 702.209 Full and Fair Disclosure of Financial Condition

The proposed rule would move the full and fair disclosure of financial condition requirements contained in the current § 702.402, and applicable to new credit unions, to new § 702.209 of the proposed rule. No substantive changes to the current full and fair disclosure of financial condition requirements for new credit unions are intended.

Section 702.210 Payment of Dividends

The proposed rule would reorganize the rules regarding the payment of dividends contained in the current § 702.403, which also apply to new credit unions, to new § 702.210 of the proposed rule. The proposed rule would make a number of amendments to the text of paragraphs (a) and (b) of the current rule, and add a new paragraph (c). Each of these changes is discussed in more detail below.

210(a) Restriction on Dividends

Current § 702.402(a) permits credit unions with a depleted undivided earnings balance to pay dividends out of the regular reserve account without regulatory approval, as long as the credit union will remain at least adequately capitalized. Proposed § 702.210(a), however, would allow only new credit unions that have substantial net worth, but no undivided earnings, to pay dividends without regulatory approval.

210(b) Payment of Dividends if Retained Earnings Depleted

Proposed § 702.210(b) would provide that well capitalized new credit unions could pay dividends only if their net worth classification do not fall below adequately capitalized. As with the current § 702.402(b)(2), proposed § 702.210(b)(2) would require approval from the appropriate Regional Director, and if state-chartered, the appropriate state official, if after payment of the dividend the credit union's net worth classification would fall below adequately capitalized. In addition, the proposed rule would require that the credit union's request for written approval include the credit union's plan for eliminating any negative retained earnings balance. Secondary capital accounts would continue to be excluded as a direct source of dividend payments. Dividends would not be considered operating losses and could not be paid out of secondary capital.

210(c) Restriction on Payments of Dividends if, After Payment of Dividends, the Credit Union's Net Worth Ratio Would Be Less Than 6 Percent

Proposed § 702.210(c) would prohibit a new credit union from unreasonably dissipating its capital through excessive dividend payments or a refund of interest in a manner that would undermine the safety and soundness of the credit union. In particular, the proposed rule would prohibit a new credit union currently classified as well capitalized from paying dividend rates that are higher than the prevailing market rates, declaring a non-repetitive dividend, or approving a refund of interest if, after the payment of the dividend or a refund of interest, the credit union's net worth ratio would decline to less than 6 percent in the current quarter. This new provision would prevent the unsafe dissipation of capital through the payment of special or bonus dividends or interest refunds while still allowing for continuity of operations.

C. Part 747—Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations

Subpart L—Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action

Section 747.2006 Review of Order Imposing Individual Minimum Capital Requirements

Section 216(k) of the FCUA provides that "material supervisory determinations, including decisions to require prompt corrective action, made . . . by [NCUA] officials other than the [NCUA] Board may be appealed to the [NCUA] Board" through an independent appellate process "pursuant to separate procedures prescribed by regulation."[73] Consistent with the requirements of section 216(k), decisions of NCUA staff to impose a discretionary supervisory action (including imposing individual minimum capital requirements on a credit union) would continue to be treated as "material supervisory determinations." Proposed § 747.2006 would require that NCUA provide reasonable prior notice and an independent process for appealing NCUA staff decisions to impose individual minimal capital requirements (IMCR) under proposed § 702.105.

2006(a) Notice of Proposed Individual Minimum Capital Requirements

Proposed § 747.2006(a) would require NCUA to provide a credit union with reasonable prior notice when NCUA proposes to impose IMCR for a particular credit union pursuant to proposed § 702.105. In addition, the proposed rule would require NCUA to forward a copy of the notifying letter to the appropriate state supervisory authority (SSA) if a state-chartered credit union would be subject to an IMCR.

[72] 12 U.S.C. 1786 and 1790d.

[73] Section 1790d(k).

2006(b) Contents of the Notice

Proposed § 747.2006(b) would require that the notice of intention to impose IMCR for a credit union based on particular capital conditions at a credit union state all of the following: (1) The credit union's net worth ratio, risk-based capital ratio and net worth classification. (2) The specific minimum capital levels that the NCUA Board intends to impose on the credit union under the IMCR, and the specific causes for determining that the higher IMCR is necessary or appropriate for the credit union. (3) The proposed schedule for compliance with the new requirement. (4) That the credit union must file a written response to the notice, which shall be no less than 30 calendar days from the date of service of the notice.

In addition, proposed § 747.2006(b) would provide that the NCUA Board may extend the time period for good cause, and that the time period for response by the insured credit union may be shortened for good cause when, in the opinion of NCUA, the condition of the credit union so requires, and NCUA informs the credit union of the shortened response period in the notice; or with the consent of the credit union.

2006(c) Contents of Response to Notice

Proposed § 747.2006(c) would require that the credit union's response to a notice under § 747.2006(b) of this section include the following: (1) An explanation of why it contends the IMCR is not an appropriate exercise of discretion under this part; (2) a request that the NCUA Board modify or not issue the IMCR; (3) any information, mitigating circumstances, documentation, or other evidence in support of the credit union's position that the credit union wants NCUA to consider in deciding whether to establish or to amend an IMCR for the credit union; and (4) if desired, a request for a recommendation from the NCUA's Ombudsman pursuant to § 747.2006(g).

2006(d) Failure To File Response

Proposed § 747.2006(d) would provide that failure by the credit union to respond within 30 days, or such other time period as may be specified by NCUA, may constitute a waiver of any objections to the proposed IMCR or to the schedule for complying with it, unless NCUA has provided an extension of the response period for good cause.

2006(e) Final Decision by NCUA

Proposed § 747.2006(e) would provide that after the expiration of the response period, NCUA will decide whether or not the proposed IMCR should be established for the credit union, or whether that proposed requirement should be adopted in modified form, based on a review of the credit union's response and other relevant information. The proposed rule would require NCUA's decision to address comments received within the response period from the credit union and the appropriate state supervisory authority (if a state-chartered credit union is involved); and to state the level of capital required, the schedule for compliance with this requirement, and any specific remedial action the credit union could take to eliminate the need for continued applicability of the IMCR. In addition, the proposal would require NCUA to provide the credit union and the appropriate SSA (if a state-chartered credit union is involved) with a written decision on the IMCR, addressing the substantive comments made by the credit union and setting forth the decision and the basis for that decision. Finally, proposed § 747.2006(e) would provide that this decision represents final agency action; and that the IMCR becomes effective and binding upon the credit union upon receipt of the decision by the credit union.

2006(f) Request To Modify or Rescind IMCR

Proposed § 747.2006(f) would provide that the IMCR shall remain in effect while such request is pending unless otherwise ordered by the NCUA Board, but would permit a credit union that is subject to an existing IMCR to request in writing that the NCUA Board reconsider the terms of the IMCR due to changed circumstances. In addition the proposed rule would provide that a request under proposed § 747.2006(f) that remains pending 60 days following receipt by the NCUA Board is deemed granted.

2006(g) Ombudsman

Proposed § 747.2006(g) would permit credit unions to request in writing the recommendation of NCUA's ombudsman to modify or to not issue a proposed IMCR under § 747.2006(b), or to modify or rescind an existing directive due to changed circumstances under § 747.2006(f). However, the proposed rule would provide that a credit union that fails to request the ombudsman's recommendation in a response under § 747.2006(c), or in a request under § 747.2006(f), shall be deemed to have waived the opportunity to do so. Finally, the proposed rule would require the ombudsman to promptly notify the credit union and the NCUA Board of his or her recommendation.

D. Other Conforming Changes to the Regulations

In addition to the amendments discussed above, the proposed rule would make minor conforming amendments to §§ 700.2, 701.21, 701.23, 701.34, 703.14, 713.6, 723.7, 747.2001, 747.2002, and 747.2003. The conforming amendments would primarily involve updating terminology and cross citations to proposed part 702 and proposed § 747.2006. No substantive changes are intended by these amendments.

III. Effective Date

How much time would credit unions have to implement these new requirements?

The proposed amendments would go into effect approximately 18 months after the publication of a final rule in the **Federal Register**. This would give credit unions lead time to plan for the new risk-based capital ratio requirements and other proposed changes to part 702. During the 18 month implementation period, credit unions would be required to continue to comply with current part 702. The Board believes this implementation period is necessary to allow credit unions to make adjustments to internal systems, balance sheets and operations well in advance of the effective date.

IV. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) [74] requires NCUA to provide an initial regulatory flexibility analysis with a proposed rule to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposed of the RFA to include credit unions with assets less than or equal to $50 million) and publish its certification and a short explanatory statement in the **Federal Register** also with the proposed rule.[75] The proposed amendments to part 702 will primarily impact only credit unions with more than $50 million in total assets. NCUA recognizes that there may, however, be some burden associated with the amendments to the current rule relating to additional data that will need to be collected on the Call Report; the elimination of the regular reserve requirement; and changes to the payment of dividends. In particular, implementation of the proposed rule will likely impose some one-time costs associated with personnel training and updates to

[74] 5 U.S.C. 601 *et seq.*

[75] 78 FR 4032 (Jan. 18, 2013).

systems for calculating regulatory capital. NCUA believes these one-time implementation costs will not constitute a significant economic impact on small credit unions. Accordingly, the NCUA Board certifies the proposed rule will not have a significant economic impact on a substantial number of small credit unions.

Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or increases an existing burden.[76] For purposes of the PRA, a paperwork burden may take the form of a reporting or recordkeeping requirement, both referred to as information collections. The proposed changes to part 702 impose new information collection requirements. As required by the PRA, NCUA is submitting a copy of this proposal to OMB for its review and approval. Persons interested in submitting comments with respect to the information collection aspects of the proposed rule should submit them to OMB at the address noted below.

NCUA has determined that the proposed changes to part 702 will have some one-time costs associated with updating internal policies, and updating data collection and reporting systems for preparing Call Reports. NCUA estimates that all 6,681 credit unions will have to amend their procedures and systems for preparing Call Reports. However, a separate notice will be published for comment on the regulatory reporting requirements.

In addition, NCUA estimates that approximately 2,606 federally insured natural person credit unions hold asset-backed investments and would be subject to the proposed due diligence requirements. Credit unions are already required to perform due diligence under §§ 703.6, 703.10, and 703.12 of NCUA's regulations. Therefore, NCUA does not believe there will be any new burden associated with this requirement.

Finally, NCUA estimates that approximately 33.5 percent, or 2,237 credit unions, will be defined as "complex" under the proposed rule and will have new data collection requirements related to the new risk-based capital requirements.

Title of Information Collection: Risk-based Capital Ratio data.

Frequency of Response: On occasion and quarterly.

Affected Public: All credit unions.

Estimated Number of Respondents: 6,681.

Estimated Burden per Respondent: One-time recordkeeping, 122 hours; ongoing recordkeeping, 20 hours; one time policy review and revision, 20 hours.

Title of Information Collection: Risk-Based Capital Ratio policy implications for complex credit unions.

Affected Public: Complex Credit Unions.

Estimated Number of Respondents: 2,237.

Estimated Burden per Respondent: One-time policy review and revision, 40 hours.

Total Estimated Annual Burden: One-time recordkeeping and disclosures, (122 hours * non-complex credit unions, or 162 hours * complex credit unions); ongoing recordkeeping and disclosures (20 hours * all credit unions).

Submission of comments. NCUA considers comments by the public on this proposed collection of information in:

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of NCUA, including whether the information will have a practical use;
- Evaluating the accuracy of NCUA's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; *e.g.*, permitting electronic submission of responses.

The PRA requires OMB to make a decision concerning the collection of information contained in the proposed regulation between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to NCUA on the substantive aspects of the proposed regulation.

Comments on the proposed information collection requirements should be sent to:

Office of Information and Regulatory Affairs, OMB, Attn: Shagufta Ahmed, Room 10226, New Executive Office Building, Washington, DC 20503, with a copy to the Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. This proposed rule will apply to all federally insured natural person credit unions, including federally insured, state-chartered natural person credit unions. Accordingly, it may have a direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. This impact is an unavoidable consequence of carrying out the statutory mandate to adopt a system of PCA to apply to all federally insured, natural person credit unions. Throughout the rulemaking process, NCUA has consulted with representatives of state regulators regarding the impact of PCA on state-chartered credit unions. The comments and suggestions of those state regulators are reflected in the proposed rule.

Assessment of Federal Regulations and Policies on Families

NCUA has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Public Law 105–277, 112 Stat. 2681 (1998).

List of Subjects

12 CFR Part 700

Credit unions.

12 CFR Part 701

Advertising, Aged, Civil rights, Credit, Credit unions, Fair housing, Individuals with disabilities, Insurance, Marital status discrimination, Mortgages, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination, Signs and symbols, Surety bonds.

12 CFR Part 702

Credit unions, Reporting and recordkeeping requirements.

12 CFR Part 703

Credit unions, Investments, Reporting and recordkeeping requirements.

12 CFR Part 713

Bonds, Credit unions, Insurance.

[76] 44 U.S.C. 3507(d); 5 CFR part 1320.

12 CFR Part 723

Credit unions, Loan programs—business, Reporting and recordkeeping requirements.

12 CFR Part 747

Administrative practice and procedure, Bank deposit insurance, Claims, Credit unions, Crime, Equal access to justice, Investigations, Lawyers, Penalties.

By the National Credit Union Administration Board on January 23, 2014.

Gerard Poliquin,

Secretary of the Board.

For the reasons discussed above, NCUA Board proposes to amend 12 CFR parts 700, 701, 702, 703, 713, 723, and 747 as follows:

PART 700—DEFINITIONS

■ 1. The authority citation for part 700 continues to read as follows:

Authority: 12 U.S.C. 1752, 1757(6), 1760.

§ 700.2 [Amended]

■ 2. Amend the definition of "net worth" in § 700.2 by removing "§ 702.2(f)" and adding in its place "§ 702.2".

PART 701—ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS

■ 3. The authority citation for part 701 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1758, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1786, 1787, 1789. Section 701.6 is also authorized by 15 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 *et seq.;* 42 U.S.C. 1981 and 3601–3610. Section 701.35 is also authorized by 42 U.S.C. 4311–4312.

§ 701.21 [Amended]

■ 4. Amend § 701.21(h)(4)(iv) by removing "§ 702.2(f)" and adding in its place "§ 702.2".

§ 701.23 [Amended]

■ 5. Amend § 701.23(b)(2) by removing the words "net worth" and adding in their place the word "capital", and removing the words "or, if subject to a risk-based net worth (RBNW) requirement under Part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement".

§ 701.34 [Amended]

■ 6. Amend § 701.34 as follows:

■ a. In paragraph (b)(12) by remove the words "§§ 702.204(b)(11), 702.304(b) and 702.305(b)" and add in their place the words "part 702".

b. In paragraph (d)(1)(i) remove the words "net worth" and add in their place the word "capital".

Appendix to § 701.34 [Amended]

■ 7. In the appendix to § 701.34, amend the paragraph beginning "8. Prompt Corrective Action" by removing the words "net worth classifications (*see* 12 CFR 702.204(b)(11), 702.304(b) and 702.305(b), as the case may be)" and adding in their place the words "capital classifications (*see* 12 CFR part 702)".

■ 8. Revise part 702 to read as follows:

PART 702—CAPITAL ADEQUACY

Sec.

702.1 Authority, purpose, scope, and other supervisory authority.
702.2 Definitions.

Subpart A—Prompt Corrective Action

702.101 Capital measures, effective date of classification, and notice to NCUA.
702.102 Capital category classification.
702.103 Applicability of risk-based capital ratio measure.
702.104 Risk-based capital ratio measure.
702.105 Individual minimum capital requirements.
702.106 Prompt corrective action for adequately capitalized credit unions.
702.107 Prompt corrective action for undercapitalized credit unions.
702.108 Prompt corrective action for significantly undercapitalized credit unions.
702.109 Prompt corrective action for critically undercapitalized credit unions.
702.110 Consultation with state officials on proposed prompt corrective action.
702.111 Net worth restoration plans (NWRP).
702.112 Reserves.
702.113 Full and fair disclosure of financial condition.
702.114 Payment of dividends.

Subpart B—Alternative Prompt Corrective Action for New Credit Unions

702.201 Scope and definition.
702.202 Net worth categories for new credit unions.
702.203 Prompt corrective action for adequately capitalized new credit unions.
702.204 Prompt corrective action for moderately capitalized, marginally capitalized, or minimally capitalized new credit unions.
702.205 Prompt corrective action for uncapitalized new credit unions.
702.206 Revised business plans (RBP) for new credit unions.
702.207 Incentives for new credit unions.
702.209 Reserves.
702.210 Full and fair disclosure of financial condition.
702.211 Payment of dividends.

Authority: 12 U.S.C. 1766(a), 1790d.

§ 702.1 Authority, purpose, scope, and other supervisory authority.

(a) *Authority.* Subparts A and B of this part and subpart L of part 747 of this chapter are issued by the National Credit Union Administration (NCUA) pursuant to sections 120 and 216 of the Federal Credit Union Act (FCUA), 12 U.S.C. 1776 and 1790d (section 1790d), as revised by section 301 of the Credit Union Membership Access Act, Public Law 105–219, 112 Stat. 913 (1998).

(b) *Purpose.* The express purpose of prompt corrective action under section 1790d is to resolve the problems of federally insured credit unions at the least possible long-term loss to the National Credit Union Share Insurance Fund. Subparts A and B of this part carry out the purpose of prompt corrective action by establishing a framework of minimum capital requirements, mandatory, and discretionary supervisory actions applicable according to a credit union's net worth classification, designed primarily to restore and improve the capital adequacy of federally insured credit unions.

(c) *Scope.* This part implements the provisions of section 1790d as they apply to federally insured credit unions, whether federally- or state-chartered; to such credit unions defined as "new" pursuant to section 1790d(b)(2); and to such credit unions defined as "complex" pursuant to section 1790d(d). Certain of these provisions also apply to officers and directors of federally insured credit unions. This part does not apply to corporate credit unions. Procedures for issuing, reviewing and enforcing orders and directives issued under this part are set forth in subpart L of part 747 of this chapter.

(d) *Other supervisory authority.* Neither section 1790d nor this part in any way limits the authority of the NCUA Board or appropriate state official under any other provision of law to take additional supervisory actions to address unsafe or unsound practices or conditions, or violations of applicable law or regulations. Action taken under this part may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA Board or appropriate state official, including issuance of cease and desist orders, orders of prohibition, suspension and removal, or assessment of civil money penalties, or any other actions authorized by law.

§ 702.2 Definitions.

Unless provided otherwise in this part, the terms used in this part have the same meanings as set forth in FCUA sections 101 and 216, 12 U.S.C. 1752, 1790d. The following definitions apply to this part:

Allowance for loan and lease loss (ALLL) means reserves that have been established through charges against earnings to absorb future losses on loans, lease financing receivables, or other extensions of credit.

Appropriate regional director means the director of the NCUA regional office having jurisdiction over federally insured credit unions in the state where the affected credit union is principally located or, for credit unions with $10 billion or more in assets, the Director of the Office of National Examinations and Supervision.

Appropriate state official means the commission, board or other supervisory authority having jurisdiction over credit unions chartered by the state which chartered the affected credit union.

Call Report means the Call Report required to be filed by all credit unions under § 741.6(a)(2) of this chapter.

Capital means the equity, as measured by GAAP, available to a credit union to cover losses.

Cash equivalents mean short-term highly liquid investments that:

(1) Have original maturities of 3 months or less, at the time of purchase;

(2) Are readily convertible to known amounts of cash; and

(3) Are used as part of the credit union's cash-management activities.

Commitment means any legally binding arrangement that obligated the credit union to extend credit or to purchase assets.

Credit union means a federally insured, natural person credit union, whether federally- or state-chartered, as defined by 12 U.S.C. 1752(6).

CUSO means a credit union service organization as defined in part 712 and 741 of this chapter.

Delinquent loans means loans that are 60 days or more past due and loans placed on nonaccrual status.

Derivatives contract means, in general, a financial instrument, traded on or off an exchange, the value of which is directly depended upon the value on or more underlying securities, equity indices, debt instruments, commodities, interest rates other derivative instruments, or any agreed upon pricing index or arrangement. Derivatives contracts include interest rate derivatives contracts and any other instrument that poses similar counterparty credit risks. Derivatives contracts also include unsettled securities with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days.

First mortgage real estate loan means loans and lines of credit fully secured by first liens on real estate (excluding MBLs), where:

(1) The original amortization of the mortgage exposure does not exceed 30 years,

(2) The loan underwriting took into account all the borrower's obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance) and assessments, and

(3) The loan underwriting concluded the borrower is able to repay the exposure using the maximum interest rate that may apply in the first five years, the maximum contract exposure over the life of the mortgage, and verified income.

GAAP means generally accepted accounting principles as used in the United States.

Goodwill means an intangible asset representing the future economic benefits arising from other assets acquired in a business combination (e.g., merger) that are not individually identified and separately recognized.

Intangible assets means those assets that are required to be reported as intangible assets in a credit union's Call Report, including but not limited to purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

Investment in CUSO means the unimpaired value of the credit union's aggregate CUSO investments as measured under GAAP on an unconsolidated basis.

Identified losses means those items that have been determined by an evaluation made by a state or federal examiner, as measured on the date of examination, to be chargeable against income, capital and/or valuation allowances such as the allowance for loan and lease losses. Examples of identified losses would be assets classified as losses, off-balance sheet items classified as losses, any provision expenses that are necessary to replenish valuation allowances to an adequate level, liabilities not shown on the books, estimated losses in contingent liabilities, and differences in accounts that represent shortages.

Loans to CUSOs means the aggregate outstanding loan balance, available line(s) of credit from the credit union, and guarantees the credit union has made to or on behalf of a CUSO.

Loans transferred with limited recourse means the total principal balance outstanding of loans transferred, including participations, for which the transfer qualified for true sale accounting treatment under GAAP, and for which the transferor credit union retained some limited recourse (i.e. insufficient recourse to preclude true sale accounting treatment). The term does not include transfers that qualify for true sale accounting treatment but contain only routine representation and warranty paragraphs that are standard for sales on the secondary market provided the credit union is in compliance with all other related requirements such as capital requirements.

Mortgage servicing asset (MSA) means those assets (net of any related valuation allowances) resulting from contracts to service loans secured by real estate (that have been securitized or owned by others) for which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing.

NCUSIF means the National Credit Union Share Insurance Fund as defined by 12 U.S.C. 1783.

Net worth means:

(1) The retained earnings balance of the credit union at quarter-end as determined under GAAP, subject to paragraph (3) of this definition. Retained earnings consists of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities.

(2) For a low income-designated credit union, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders, and the NCUSIF.

(3) For a credit union that acquires another credit union in a mutual combination, net worth also includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, less any bargain purchase gain recognized in either case to the extent the difference between the two is greater than zero. The acquired retained earnings must be determined at the point of acquisition under generally accepted accounting principles. A mutual combination is a transaction in which a credit union acquires another credit union or acquires an integrated set of activities and assets that is capable of being conducted and managed as a credit union.

(4) The term "net worth" also includes loans to and accounts in an insured credit union, established pursuant to section 208 of the Act [12 U.S.C. 1788], provided such loans and accounts:

(i) Have a remaining maturity of more than 5 years;

(ii) Are subordinate to all other claims including those of shareholders, creditors, and the NCUSIF;

(iii) Are not pledged as security on a loan to, or other obligation of, any party;

(iv) Are not insured by the NCUSIF;

(v) Have non-cumulative dividends;

(vi) Are transferable; and

(vii) Are available to cover operating losses realized by the insured credit union that exceed its available retained earnings.

Net worth ratio means the ratio of the net worth of the credit union to the total assets of the credit union rounded to two decimal places.

New credit union means a federally insured credit union which both has been in operation for less than ten (10) years and has $10,000,000 or less in total assets.

Off-balance sheet items means items such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements that are not included on the balance sheet but are normally reported in the financial statement footnotes.

Qualifying master netting agreement means a written, legally enforceable agreement, provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement provides the credit union the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of conservatorship, receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or under any similar insolvency law applicable to GSEs;

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate is a net creditor under the agreement); and

(4) In order to recognize an agreement as a qualifying master netting agreement for purposes of this part, a credit union must conduct sufficient legal review, at origination and in response to any changes in applicable law, to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that:

(i) The agreement meets the requirements of paragraph (2) of this definition of qualifying master netting agreement; and

(ii) In the event of a legal challenge (including one resulting from default or from conservatorship, receivership, insolvency, liquidation, or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of relevant jurisdictions.

Risk-based capital ratio means the percentage, rounded to two decimal places, of the risk-based capital numerator to total risk-weighted assets, as calculated in accordance with § 702.104(a).

Risk-weighted assets means the total risk-weighted assets as calculated in accordance with § 702.104(c).

Senior executive officer means a senior executive officer as defined by § 701.14(b)(2) of this chapter.

Shares means deposits, shares, share certificates, share drafts, or any other depository account authorized by federal or state law.

Total assets. (1) For each quarter, a credit union must elect one of the measures of total assets listed in paragraph (2) of this definition to apply for all purposes under this part except §§ 702.103 through 702.105 (risk-based capital ratio requirements).

(2) Total assets means a credit union's total assets as measured by either—

(i) *Average quarterly balance.* The credit union's total assets measured by the average of quarter-end balances of the current and three preceding calendar quarters;

(ii) *Average monthly balance.* The credit union's total assets measured by the average of month-end balances over the three calendar months of the applicable calendar quarter;

(iii) *Average daily balance.* The credit union's total assets measured by the average daily balance over the applicable calendar quarter; or

(iv) *Quarter-end balance.* The credit union's total assets measured by the quarter-end balance of the applicable calendar quarter as reported on the credit union's Call Report.

U.S. Government agency means an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

Verified Income means receipt and retention of corroborative information to establish the reality of the income supporting the repayment of the loan.

Weighted-average life of investments means:

(1) For investments in registered investment companies (e.g., mutual funds) and collective investment funds (e.g., common trusts), the maximum weighted-average life or duration target of the investment disclosed, directly or indirectly, in the most recent prospectus or trust instrument (if the maximum weighted-average life or duration target is not disclosed, the weighted-average life of investments means greater than 5 years, but less than 10 years);

(2) For investments in money market funds, as defined in 17 CFR 270.2a–7, and collective investment funds operated in accordance with short-term investment fund rules set forth in 12 CFR 9.18(b)(4)(ii)(B)(*1*) through (*3*), 1 year or less;

(3) For fixed rate debt obligations and deposits that are callable in whole, the period remaining to the maturity date;

(4) For fixed rate debt obligations and deposits that are non-callable and non-amortizing (e.g., bullet maturity instruments), the period remaining to the maturity date;

(5) For fixed rate debt obligations or deposits with periodic principal pay downs (e.g., mortgage-backed securities), the weighted-average life of investments as defined according to industry standard calculations, which include the impact of unscheduled payments;

(6) For variable rate debt obligations and deposits (regardless of whether the investment amortizes), the period remaining to the next rate adjustment date;

(7) For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), greater than 1 year but less than or equal to 3 years;

(8) For other equity securities, greater than 10 years.

(9) For any other investments not addressed above, the average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time it is expected to be received (based on a reasonable and supportable estimate of that time), and then taking the total of these time-weighted payments and dividing by the total amount of principal.

Subpart A—Prompt Corrective Action

§ 702.101 Capital measures, effective date of classification, and notice to NCUA.

(a) *Capital measure.* For purposes of this part, a credit union must determine its capital classification at the end of each calendar quarter using the following measures:

(1) The net worth ratio; and

(2) If determined to be applicable under § 702.103, the risk-based capital ratio.

(b) *Effective date of capital classification.* For purposes of this part, the effective date of a federally insured credit union's capital classification shall be the most recent to occur of:

(1) *Quarter-end effective date.* The last day of the calendar month following the end of the calendar quarter; or

(2) *Corrected capital classification.* The date the credit union received subsequent written notice from NCUA or, if state-chartered, from the appropriate state official, of a decline in capital classification due to correction of an error or misstatement in the credit union's most recent Call Report; or

(3) *Reclassification to lower category.* The date the credit union received written notice from NCUA or, if state-chartered, the appropriate state official, of reclassification on safety and soundness grounds as provided under §§ 702.102(b) or 702. 202(d).

(c) *Notice to NCUA by filing Call Report.* (1) Other than by filing a Call Report, a federally insured credit union need not notify the NCUA Board of a change in its capital measures that places the credit union in a lower capital category;

(2) Failure to timely file a Call Report as required under this section in no way alters the effective date of a change in capital classification under paragraph (b) of this section, or the affected credit union's corresponding legal obligations under this part.

§ 702.102 Capital classifications.

(a) *Capital categories.* Except for credit unions defined as "new" under subpart B of this part, a credit union shall be deemed to be classified (Table 1 of this section)—

(1) *Well capitalized* if:

(i) *Net worth ratio.* The credit union has a net worth ratio of 7.0 percent or greater; and

(ii) *Risk-based capital ratio.* The credit union, if complex, has a total risk-based capital ratio of 10.5 percent or greater.

(2) *Adequately capitalized* if:

(i) *Net worth ratio.* The credit union has a net worth ratio of 6.0 percent or greater; and

(ii) *Risk-based capital ratio.* The credit union, if complex, has a total risk-based capital ratio of 8.0 percent or greater.

(3) *Undercapitalized* if:

(i) *Net worth ratio.* The credit union has a net worth ratio of 4.0 percent or greater; and

(ii) *Risk-based capital ratio.* The credit union, if complex, fails to meet the minimum 8.0 percent total risk based capital requirement.

(4) *Significantly undercapitalized* if:

(i) The credit union meets the definition of undercapitalized, has a net worth ratio of less than 5.0 percent, and has received notice that its net worth restoration plan has not been approved (to qualify for a higher net worth classification, a significantly undercapitalized credit union must have a net worth restoration plan approved by NCUA);

(ii) The credit union has a net worth ratio of 2.0 percent or more but less than 4.0 percent; or

(iii) The credit union has a net worth ratio of 4.0 percent or more but less than 5.0 percent, and either—

(A) Fails to submit an acceptable net worth restoration plan within the time prescribed in § 702.111; or

(B) Materially fails to implement a net worth restoration plan approved by the NCUA Board.

(5) *Critically undercapitalized* if it has a net worth ratio of less than 2.0 percent.

TABLE 1 TO § 702.102—CAPITAL CATEGORIES

A credit union's capital classification is . . .	Net worth ratio	Risk-based capital ratio	And subject to following condition(s) . . .
Well Capitalized	7% or above	10.5% or above	Must pass both net worth ratio and risk-based capital ratio.
Adequately Capitalized	6% to 6.99%	8% to 10.49%	Must pass both net worth ratio and risk-based capital ratio.
Undercapitalized	4% to 5.99%	Less than 8%	Must pass both net worth ratio and risk-based capital ratio.
Significantly Undercapitalized.	2% to 3.99%	N/A	Or if "undercapitalized at < 5% net worth and fails to timely submit or materially implement an approved net worth restoration plan.
Critically Undercapitalized	Less than 2%	N/A	None.

(b) *Reclassification based on supervisory criteria other than net worth.* The NCUA Board may reclassify a well capitalized credit union as adequately capitalized and may require an adequately capitalized or undercapitalized credit union to comply with certain mandatory or discretionary supervisory actions as if it were classified in the next lower capital category (each of such actions hereinafter referred to generally as "reclassification") in the following circumstances:

(1) *Unsafe or unsound condition.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union is in an unsafe or unsound condition; or

(2) *Unsafe or unsound practice.* The NCUA Board has determined, after notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the credit union has not corrected a material unsafe or unsound practice of which it was, or should have been, aware.

(c) *Non-delegation.* The NCUA Board may not delegate its authority to reclassify a credit union under paragraph (b) of this section.

(d) *Consultation with state officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before reclassifying a federally insured state-chartered credit union under paragraph (b) of this section, and shall promptly notify the appropriate state official of its decision to reclassify.

§ 702.103 Applicability of risk-based capital ratio measure.

For purposes of § 702.102, a credit union is defined as "complex" and a risk-based capital ratio requirement is applicable only if the credit union's quarter-end total assets exceed fifty million dollars ($50,000,000), as reflected in its most recent Call Report.

§ 702.104 Risk-based capital ratio measures.

A complex credit union must calculate its risk-based capital ratio in accordance with this section.

(a) *Calculation of the risk-based capital ratio.* To determine its risk-based capital ratio a complex credit union must calculate the percentage, rounded to two decimal places, of its risk-based capital numerator as described in paragraph (b) of this section to its total risk-weighted assets as described in paragraph (c) of this section.

(b) *Risk-based capital ratio numerator.* The risk-based capital ratio numerator is the sum of the specific capital elements in paragraph (b)(1) of this section, minus the regulatory adjustments in paragraph (b)(2) of this section.

(1) *Capital elements of the risk-based capital ratio numerator.* The capital elements of the risk-based capital numerator are:

(i) Undivided earnings (including any regular reserve);

(ii) Appropriation for non-conforming investments;

(iii) Other reserves;

(iv) Equity acquired in merger;

(v) Net income;

(vi) ALLL, limited to 1.25% of risk assets;

(vii) Secondary capital accounts included in net worth (as defined in § 702.2); and

(viii) Section 208 assistance included in net worth (as defined in § 702.2).

(2) *Risk-based capital numerator deductions.* The elements deducted from the sum of the risk-based capital elements are:

(i) NCUSIF Capitalization Deposit;

(ii) Goodwill;

(iii) Other intangible assets; and

(iv) Identified losses not reflected in the risk-based capital ratio numerator.

(c) *Total risk-weighted assets.* (1) *General.* Total risk-weighted assets includes risk-weighted on-balance sheet assets as described in paragraph (c)(2) of this section, plus the risk-weighted off-balance sheet assets in paragraph (c)(3) of this section, plus the risk-weighted derivatives in paragraph (c)(4) of this section, less the risk-based capital numerator deductions in paragraph (b)(2) of this section.

(2) *Risk-weights for on-balance sheet assets.* The risk categories and weights for assets listed on a complex credit union's balance sheet are as follows:

(i) *Category 1—zero percent risk-weight.* A credit union must assign a zero percent risk-weight to:

(A) Cash on hand, which includes the change fund (coin, currency, and cash items), vault cash, vault funds in transit and currency supplied from automatic teller machines.

(B) NCUSIF capital deposit.

(C) Debt instruments unconditionally guaranteed by the NCUA or the Federal Deposit Insurance Corporation.

(D) U.S. Government obligations directly and unconditionally guaranteed by the full faith and credit of the U.S. Government, including U.S. Treasury bills, notes, bonds, zero coupon bonds, and separate trading of registered interest and principal securities (STRIPS).

(E) Non-delinquent student loans unconditionally guaranteed by a U.S. Government agency.

(ii) *Category 2—20 percent risk-weight.* A credit union must assign a 20 percent risk-weight to:

(A) Cash on deposit, which includes balances on deposit in insured financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check, and they may or may not bear interest. Examples include overnight accounts, corporate credit union daily accounts, money market accounts, and checking accounts.

(B) Cash equivalents (investments with original maturities of three months or less). Cash equivalents are short-term, highly liquid non-security investments that have an original maturity of 3 months or less at the time of purchase, are readily convertible to known amounts of cash, and are used as part of the credit union's cash management activities.

(C) The total amount of investments with a weighted-average life of one year or less.

(D) Residential mortgages guaranteed by the U.S. Government through the Federal Housing Administration or the Department of Veterans Affairs.

(E) Loans guaranteed 75 percent or more by the Small Business Administration, U.S. Department of Agriculture, or other U.S. Government agency.

(iii) *Category 3—50 percent risk-weight.* A credit union must assign a 50 percent risk-weight to:

(A) The total amount of investments with a weighted-average life of greater than one year, but less than or equal to three years.

(B) The total amount of current and non-delinquent first mortgage real estate loans less than or equal to 25 percent of total assets.

(iv) *Category 4—75 percent risk-weight.* A credit union must assign a 75 percent risk-weight to:

(A) The total amount of investments with a weighted-average life of greater than three years, but less than or equal to five years.

(B) Current and non-delinquent unsecured credit card loans, other unsecured loans and lines of credit, short-term, small amount loans (STS), new vehicle loans, used vehicle loans, leases receivable and all other loans. (Excluding loans reported as member business loans).

(C) Current and non-delinquent first mortgage real estate loans greater than 25 percent of total assets and less than or equal to 35 percent of assets.

(v) *Category 5—100 percent risk-weight.* A credit union must assign a 100 percent risk-weight to:

(A) Corporate credit union nonperpetual capital.

(B) The total outstanding principal amount of loans to CUSOs.

(C) Current and non-delinquent first mortgage real estate loans greater than 35 percent of total assets.

(D) Delinquent first mortgage real estate loans.

(E) Other real estate-secured loans less than or equal to 10 percent of assets.

(F) Member business loans less than or equal to 15 percent of assets.

(G) Loans held for sale.

(H) The total amount of any foreclosures and repossessed assets.

(I) Land and building, less depreciation on building.

(J) Any other fixed assets, such as furniture and fixtures and leasehold improvements, less related depreciation.

(K) Current non-federally insured student loans.

(L) All other assets not specifically assigned a risk-weight but included in the balance sheet.

(vi) *Category 6—125 percent risk-weight.* A credit union must assign a 125 percent risk-weight to the total amount of all other real estate-secured loans greater than 10 percent of assets and less than or equal to 20 percent of assets.

(vii) *Category 7—150 percent risk-weight.* A credit union must assign a 150 percent risk-weight to:

(A) The total amount of investments with a weighted-average life of greater than five years, but less than or equal to ten years.

(B) Any delinquent unsecured credit card loans; other unsecured loans and lines of credit; short-term, small amount loans; non-federally guaranteed student loans; new vehicle loans; used vehicle loans; leases receivable; and all other loans (excluding loans reported as member business loans).

(C) The total amount of all other real estate-secured loans greater than 20 percent of assets.

(D) Any member business loans greater than 15 percent of assets and less than or equal to 25 percent of assets.

(viii) *Category 8—200 percent risk-weight.* A credit union must assign a 200 percent risk-weight to:

(A) Corporate credit union perpetual capital.

(B) The total amount of investments with a weighted-average life of greater than 10 years.

(C) The total amount of member business loans greater than 25 percent of assets, other than member business loans included in Category 3 (paragraph (c)(2)(iii) of this section).

(ix) *Category 9—250 percent risk-weight.* A credit union must assign a 250 percent risk-weight to:

(A) The total value of investments in CUSOs.

(B) The total value of mortgage servicing assets.

(x) *Category 10—1,250 percent risk-weight.* A credit union must assign a 1,250 percent risk-weight (8% * 1,250% = 100%) to an asset-backed investment for which the credit union is unable to demonstrate, as required under paragraph (d) of this section, a comprehensive understanding of the features of the asset-backed investment that would materially affect its performance.

(3) *Risk-weights for off-balance sheet activities.* The risk-weighted amounts for all off-balance sheet items are determined by multiplying the notional principal, or face value, by the appropriate conversion factor and the assigned risk-weight as follows:

(i) A 75 percent conversion factor with a 100 percent risk-weight for unfunded commitments for member business loans.

(ii) A 75 percent conversion factor with a 100 percent risk-weight for member business loans transferred with limited recourse.

(iii) A 75 percent conversion factor with a 50 percent risk-weight for first mortgage real estate loans transferred with limited recourse.

(iv) A 75 percent conversion factor with a 100 percent risk-weight for other real estate loans transferred with limited recourse.

(v) A 75 percent conversion factor with a 100 percent risk-weight for non-federally guaranteed student loans transferred with limited recourse.

(vi) A 75 percent conversion factor with a 75 percent risk-weight for all other loans transferred with limited recourse.

(vii) A 10 percent conversion factor with a 75 percent risk-weight for total unfunded commitments for non-business loans.

(4) *Derivatives.* (i) *Single derivatives contract exposure amount.* Except as modified by paragraph (c)(4)(iii) of this section, the exposure amount for a single derivatives contract that is not subject to a qualifying master netting agreement is equal to the sum of the credit union's current credit exposure and potential future credit exposure (PFE) on the derivatives contract.

(A) *Current credit exposure.* The current credit exposure for a single derivatives contract is the greater of the mark-to-fair value of the derivatives contract or zero.

(B) *Potential future credit exposure (PFE).* (*1*) The PFE for a single derivatives contract, including a derivatives contract with a negative mark-to-fair value, is calculated by multiplying the notional principal amount of the derivatives contract by the appropriate conversion factor in Table 1 of this section.

(*2*) For a derivatives contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero, the remaining maturity equals the time until the next reset date.

(*3*) For an interest rate derivatives contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

TABLE 1 TO § 702.104—CONVERSION FACTOR MATRIX FOR DERIVATIVES CONTRACTS

Remaining maturity	Interest rate	Other
One year or less	0.00	0.10
Greater than one year and less than or equal to five years	0.005	0.12
Greater than five years	0.015	0.15

(ii) *Multiple derivatives contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (c)(4)(iii) of this section, the exposure amount for multiple derivatives contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE amounts for all derivatives contracts subject to the qualifying master netting agreement.

(A) *Net current credit exposure.* The net current credit exposure is the greater of the net sum of all positive and negative mark-to-fair values of the individual derivatives contracts subject to the qualifying master netting agreement or zero.

(B) *Adjusted sum of the PFE amounts.* The adjusted sum of the PFE amounts, Anet, is calculated as Anet = (0.4 × Agross) + (0.6 × NGR × Agross), where:

(*1*) Agross equals the gross PFE (that is, the sum of the PFE amounts as determined under paragraph (c)(4)(i)(B) of this section for each individual derivatives contract subject to the qualifying master netting agreement); and

(*2*) Net-to-gross Ratio (NGR) equals the ratio of the net current credit exposure to the gross current credit exposure. In calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under paragraph(c)(4)(i)(A) of this section) of all individual derivatives contracts subject to the qualifying master netting agreement.

(iii) *Recognition of credit risk mitigation of collateralized derivatives contracts.* A credit union may recognize the credit risk mitigation benefits of financial collateral that secures a derivatives contract or multiple derivatives contracts subject to a qualifying master netting agreement (netting set) by using the simple approach in paragraph (c)(4)(v) of this section.

(iv) *Alternative approach.* As an alternative to the simple approach, a credit union may recognize the credit risk mitigation benefits of financial collateral that secures such a contract or netting set if the financial collateral is marked-to-fair value on a daily basis and subject to a daily margin maintenance requirement by applying a risk-weight to the exposure as if it were uncollateralized and adjusting the exposure amount calculated under paragraph (c)(4)(i) of this section using the collateral approach in paragraph (c)(4)(v) of this section. The credit union must substitute the exposure amount calculated under paragraph (c)(4)(i)(A) or (B) of this section for exposure amount in the equation in paragraph (c)(4)(v).

(v) *Collateralized transactions.* (A) *General.* A credit union may use the approach in paragraph (c)(4)(v)(B) of this section to recognize the risk-mitigating effects of financial collateral.

(B) *Simple collateralized derivatives approach.* To qualify for the simple approach, the financial collateral must meet the following requirements:

(*1*) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(*2*) The collateral must be revalued at least every six months; and

(*3*) The collateral and the exposure must be denominated in the same currency.

(C) *Risk-weight substitution.* (*1*) A credit union may apply a risk-weight to the portion of an exposure that is secured by the fair value of financial collateral (that meets the requirements for the simple collateralized approach of this section) based on the risk-weight assigned to the collateral as established under § 702.104(c).

(*2*) A credit union must apply a risk-weight to the unsecured portion of the exposure based on the risk-weight applicable to the exposure under this subpart.

(D) *Exceptions to the 20 percent risk-weight floor and other requirements.* Notwithstanding the simple collateralized derivatives approach in paragraph (c)(4)(v)(B) of this section:

(*1*) A credit union may assign a zero percent risk-weight to an exposure to a derivatives contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.

(*2*) A credit union may assign a 10 percent risk-weight to an exposure to an derivatives contract that is marked-to-market daily and subject to a daily margin maintenance requirement, to the extent that the contract is collateralized by an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(ii).

(E) A credit union may assign a zero percent risk-weight to the collateralized portion of an exposure where:

(*1*) The financial collateral is cash on deposit; or

(*2*) The financial collateral is an exposure that qualifies for a zero percent risk-weight under § 702.104(c)(2)(ii), and the credit union has discounted the fair value of the collateral by 20 percent.

(d) *Due diligence requirements for asset-backed investments.* (1) If a credit union is unable to demonstrate to the NCUA a comprehensive understanding of the features of an asset-backed investment exposure that would materially affect the performance of the exposure, the credit union must assign a 1,250 percent risk-weight to the asset-backed investment exposure. The credit union's analysis must be commensurate with the complexity of the asset-backed investment and the materiality of the position in relation to regulatory capital according to this part.

(2) A credit union must demonstrate its comprehensive understanding of an asset-backed investment exposure under paragraph (d)(1) of this section, for each asset-backed investment exposure by:

(i) Conducting an analysis of the risk characteristics of an investment exposure prior to acquiring the exposure and documenting such analysis within three business days after acquiring the exposure, considering:

(A) Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and

(D) For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and

(ii) On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under this section for each investment exposure.

§ 702.105 Individual minimum capital requirements.

(a) *General.* The rules and procedures specified in this paragraph (a) apply to the establishment of an individual minimum capital requirement for a credit union that varies from any of the risk-based capital requirement(s) that would otherwise apply to the credit union under this part.

(b) *Appropriate considerations for establishing individual minimum capital requirements.* Minimum capital levels higher than the risk-based capital requirements under this part may be appropriate for individual credit unions. NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is or may become inadequate in view of the credit union's circumstances. For example, higher capital levels may be appropriate when NCUA determines that:

(1) A credit union is receiving special supervisory attention;

(2) A credit union has or is expected to have losses resulting in capital inadequacy;

(3) A credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk;

(4) A credit union has poor liquidity or cash flow;

(5) A credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not adequately addressed by other NCUA regulations or other guidance;

(6) A credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit;

(7) A credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or which has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms;

(8) A credit union has inadequate underwriting policies, standards, or procedures for its loans and investments;

(9) A credit union has failed to properly plan for, or execute, necessary retained earnings growth, or

(10) A credit union has a record of operational losses that exceeds the

average of other similarly situated credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

(c) *Standards for determination of appropriate individual minimum capital requirements.* The appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based, in part, on subjective judgment grounded in agency expertise. The factors to be considered in NCUA's determination will vary in each case and may include, for example:

(1) The conditions or circumstances leading to the determination that a higher minimum capital requirement is appropriate or necessary for the credit union;

(2) The urgency of those circumstances or potential problems;

(3) The overall condition, management strength, and future prospects of the credit union and, if applicable, its subsidiaries, affiliates, and business partners;

(4) The credit union's liquidity, capital, and other indicators of financial stability, particularly as compared with those of similarly situated credit unions; and

(5) The policies and practices of the credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices.

§ 702.106 Prompt corrective action for adequately capitalized credit unions.

(a) *Earnings retention.* Beginning on the effective date of classification as adequately capitalized or lower, a federally insured credit union must increase the dollar amount of its net worth quarterly either in the current quarter, or on average over the current and three preceding quarters, by an amount equivalent to at least 1/10th percent (0.1%) of its total assets (or more by choice), until it is well capitalized.

(b) *Decrease in retention.* Upon written application received no later than 14 days before the quarter end, the NCUA Board, on a case-by-case basis, may permit a credit union to increase the dollar amount of its net worth by an amount that is less than the amount required under paragraph (a) of this section, to the extent the NCUA Board determines that such lesser amount—

(1) Is necessary to avoid a significant redemption of shares; and

(2) Would further the purpose of this part.

(c) *Decrease by FISCU.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before permitting a federally insured state-chartered credit union to decrease its earnings retention under paragraph (b) of this section.

(d) *Periodic review.* A decision under paragraph (b) of this section to permit a credit union to decrease its earnings retention is subject to quarterly review and revocation except when the credit union is operating under an approved net worth restoration plan that provides for decreasing its earnings retention as provided under paragraph (b) of this section.

§ 702.107 Prompt corrective action for undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111, *provided however*, that a credit union in this category having a net worth ratio of less than five percent (5%) which fails to timely submit such a plan, or which materially fails to implement an approved plan, is classified significantly undercapitalized pursuant to § 702.102(a)(4)(ii);

(3) *Restrict increase in assets.* Beginning the effective date of classification as undercapitalized or lower, not permit the credit union's assets to increase beyond its total assets for the preceding quarter unless—

(i) *Plan approved.* The NCUA Board has approved a net worth restoration plan which provides for an increase in total assets and—

(A) The assets of the credit union are increasing consistent with the approved plan; and

(B) The credit union is implementing steps to increase the net worth ratio consistent with the approved plan;

(ii) *Plan not approved.* The NCUA Board has not approved a net worth restoration plan and total assets of the credit union are increasing because of increases since quarter-end in balances of:

(A) Total accounts receivable and accrued income on loans and investments; or

(B) Total cash and cash equivalents; or

(C) Total loans outstanding, not to exceed the sum of total assets plus the quarter-end balance of unused commitments to lend and unused lines of credit provided however that a credit union which increases a balance as permitted under paragraphs (a)(3)(ii)(A), (B) or (C) of this section cannot offer rates on shares in excess of prevailing rates on shares in its relevant market area, and cannot open new branches;

(4) *Restrict member business loans.* Beginning the effective date of classification as undercapitalized or lower, not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *Second tier discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to an undercapitalized credit union having a net worth ratio of less than five percent (5%), or a director, officer or employee of such a credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, unless the NCUA Board has approved the credit union's net worth restoration plan, the credit union is implementing its plan, and the NCUA Board determines that the proposed action is consistent with and will further the objectives of that plan;

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to reduce or divest its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates the credit union pays on shares to the prevailing rates paid on comparable accounts and maturities in the relevant market area, as determined by the NCUA Board, except that dividend rates already declared on shares acquired before imposing a restriction under this paragraph may not be retroactively restricted;

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce its assets or a category of assets;

(5) *Alter, reduce, or terminate activity.* Require the credit union or its CUSO to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however*, that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(8) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval); and

(9) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (8) of this section.

(c) *First tier application of discretionary supervisory actions.* An undercapitalized credit union having a net worth ratio of five percent (5%) or more, or which is classified undercapitalized by reason of failing to satisfy a risk-based net worth requirement under § 702.104, is subject to the discretionary supervisory actions in paragraph (b) of this section if it fails to comply with any mandatory supervisory action in paragraph (a) of this section or fails to timely implement an approved net worth restoration plan under § 702.111, including meeting its prescribed steps to increase its net worth ratio.

§ 702.108 Prompt corrective action for significantly undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is significantly undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.107(a)(3); and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.107(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any significantly undercapitalized credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided in § 702.107(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates that the credit union pays on shares as provided in § 702.107(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however*, that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Except with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as significantly undercapitalized, and prohibit payment of a bonus or profit share to such officer;

(11) *Other actions to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (10) of this section; and

(12) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Discretionary conservatorship or liquidation if no prospect of becoming adequately capitalized.* Notwithstanding any other actions required or permitted to be taken under this section, when a credit union becomes significantly undercapitalized (including by reclassification under § 702.102(b)), the NCUA Board may place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F); or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming adequately capitalized.

§ 702.109 Prompt corrective action for critically undercapitalized credit unions.

(a) *Mandatory supervisory actions by credit union.* A credit union which is critically undercapitalized must—

(1) *Earnings retention.* Increase net worth in accordance with § 702.106;

(2) *Submit net worth restoration plan.* Submit a net worth restoration plan pursuant to § 702.111;

(3) *Restrict increase in assets.* Not permit the credit union's total assets to increase except as provided in § 702.107(a)(3); and

(4) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as provided in § 702.107(a)(4).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures for issuing, reviewing and enforcing directives set forth in subpart L of part 747 of this chapter, the NCUA Board may, by directive, take one or more of the following actions with respect to any critically undercapitalized credit union, or a director, officer or employee of such credit union, if it determines that those actions are necessary to carry out the purpose of this part:

(1) *Requiring prior approval for acquisitions, branching, new lines of business.* Prohibit a credit union from, directly or indirectly, acquiring any interest in any business entity or financial institution, establishing or acquiring any additional branch office, or engaging in any new line of business, except as provided by § 702.107(b)(1);

(2) *Restricting transactions with and ownership of CUSO.* Restrict the credit union's transactions with a CUSO, or require the credit union to divest or reduce its ownership interest in a CUSO;

(3) *Restricting dividends paid.* Restrict the dividend rates that the credit union pays on shares as provided in § 702.107(b)(3);

(4) *Prohibiting or reducing asset growth.* Prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce assets or a category of assets;

(5) *Alter, reduce or terminate activity.* Require the credit union or its CUSO(s) to alter, reduce, or terminate any activity which poses excessive risk to the credit union;

(6) *Prohibiting nonmember deposits.* Prohibit the credit union from accepting all or certain nonmember deposits;

(7) *New election of directors.* Order a new election of the credit union's board of directors;

(8) *Dismissing director or senior executive officer.* Require the credit union to dismiss from office any director or senior executive officer, *provided however,* that a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. 1786(g);

(9) *Employing qualified senior executive officer.* Require the credit union to employ qualified senior executive officers (who, if the NCUA Board so specifies, shall be subject to its approval);

(10) *Restricting senior executive officers' compensation.* Reduce or, with the prior written approval of the NCUA Board, limit compensation to any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four (4) calendar quarters preceding the effective date of classification of the credit union as critically undercapitalized, and prohibit payment of a bonus or profit share to such officer;

(11) *Restrictions on payments on uninsured secondary capital.* Beginning 60 days after the effective date of classification of a credit union as critically undercapitalized, prohibit payments of principal, dividends or interest on the credit union's uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law;

(12) *Requiring prior approval.* Require a critically undercapitalized credit union to obtain the NCUA Board's prior written approval before doing any of the following:

(i) Entering into any material transaction not within the scope of an approved net worth restoration plan (or approved revised business plan under subpart C of this part);

(ii) Extending credit for transactions deemed highly leveraged by the NCUA Board or, if state-chartered, by the appropriate state official;

(iii) Amending the credit union's charter or bylaws, except to the extent necessary to comply with any law, regulation, or order;

(iv) Making any material change in accounting methods; and

(v) Paying dividends or interest on new share accounts at a rate exceeding the prevailing rates of interest on insured deposits in its relevant market area;

(13) *Other action to carry out prompt corrective action.* Restrict or require such other action by the credit union as the NCUA Board determines will carry out the purpose of this part better than any of the actions prescribed in paragraphs (b)(1) through (12) of this section; and

(14) *Requiring merger.* Require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i).

(c) *Mandatory conservatorship, liquidation or action in lieu thereof*—(1) *Action within 90 days.* Notwithstanding any other actions required or permitted to be taken under this section (and regardless of a credit union's prospect of becoming adequately capitalized), the NCUA Board must, within 90 calendar days after the effective date of classification of a credit union as critically undercapitalized—

(i) *Conservatorship.* Place the credit union into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(G); or

(ii) *Liquidation.* Liquidate the credit union pursuant to 12 U.S.C. 1787(a)(3)(A)(ii); or

(iii) *Other corrective action.* Take other corrective action, in lieu of conservatorship or liquidation, to better achieve the purpose of this part, provided that the NCUA Board documents why such action in lieu of conservatorship or liquidation would do so, *provided however,* that other corrective action may consist, in whole or in part, of complying with the quarterly timetable of steps and meeting the quarterly net worth targets prescribed in an approved net worth restoration plan.

(2) *Renewal of other corrective action.* A determination by the NCUA Board to take other corrective action in lieu of conservatorship or liquidation under paragraph (c)(1)(iii) of this section shall expire after an effective period ending no later than 180 calendar days after the determination is made, and the credit union shall be immediately placed into conservatorship or liquidation under paragraphs (c)(1)(i) and (ii) of this section, unless the NCUA Board makes a new determination under paragraph (c)(1)(iii) of this section before the end of the effective period of the prior determination;

(3) *Mandatory liquidation after 18 months*—(i) *Generally.* Notwithstanding paragraphs (c)(1) and (2) of this section, the NCUA Board must place a credit union into liquidation if it remains critically undercapitalized for a full calendar quarter, on a monthly average basis, following a period of 18 months from the effective date the credit union was first classified critically undercapitalized.

(ii) *Exception.* Notwithstanding paragraph (c)(3)(i) of this section, the NCUA Board may continue to take other corrective action in lieu of liquidation if it certifies that the credit union—

(A) Has been in substantial compliance with an approved net worth restoration plan requiring consistent improvement in net worth since the date the net worth restoration plan was approved;

(B) Has positive net income or has an upward trend in earnings that the NCUA Board projects as sustainable; and

(C) Is viable and not expected to fail.

(iii) *Review of exception.* The NCUA Board shall, at least quarterly, review the certification of an exception to liquidation under paragraph (c)(3)(ii) of this section and shall either—

(A) Recertify the credit union if it continues to satisfy the criteria of paragraph (c)(3)(ii) of this section; or

(B) Promptly place the credit union into liquidation, pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), if it fails to satisfy the criteria of paragraph (c)(3)(ii) of this section.

(4) *Nondelegation.* The NCUA Board may not delegate its authority under paragraph (c) of this section, unless the

credit union has less than $5,000,000 in total assets. A credit union shall have a right of direct appeal to the NCUA Board of any decision made by delegated authority under this section within ten (10) calendar days of the date of that decision.

(d) *Mandatory liquidation of insolvent federal credit union.* In lieu of paragraph (c) of this section, a critically undercapitalized federal credit union that has a net worth ratio of less than zero percent (0%) may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

§ 702.110 Consultation with state officials on proposed prompt corrective action.

(a) *Consultation on proposed conservatorship or liquidation.* Before placing a federally insured state-chartered credit union into conservatorship (pursuant to 12 U.S.C. 1786(h)(1)(F) or (G)) or liquidation (pursuant to 12 U.S.C. 1787(a)(3)) as permitted or required under subparts A or B of this part to facilitate prompt corrective action—

(1) The NCUA Board shall seek the views of the appropriate state official (as defined in § 702.2), and give him or her an opportunity to take the proposed action;

(2) The NCUA Board shall, upon timely request of the appropriate state official, promptly provide him or her with a written statement of the reasons for the proposed conservatorship or liquidation, and reasonable time to respond to that statement; and

(3) If the appropriate state official makes a timely written response that disagrees with the proposed conservatorship or liquidation and gives reasons for that disagreement, the NCUA Board shall not place the credit union into conservatorship or liquidation unless it first considers the views of the appropriate state official and determines that—

(i) The NCUSIF faces a significant risk of loss if the credit union is not placed into conservatorship or liquidation; and

(ii) Conservatorship or liquidation is necessary either to reduce the risk of loss, or to reduce the expected loss, to the NCUSIF with respect to the credit union.

(b) *Nondelegation.* The NCUA Board may not delegate any determination under paragraph (a)(3) of this section.

(c) *Consultation on proposed discretionary action.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before taking any discretionary supervisory action under §§ 702.107(b), 702.108(b), 702.109(b), 702.204(b) and 702.205(b) with respect to a federally insured state-chartered credit union; shall provide prompt notice of its decision to the appropriate state official; and shall allow the appropriate state official to take the proposed action independently or jointly with NCUA.

§ 702.111 Net worth restoration plans (NWRP).

(a) *Schedule for filing*—(1) *Generally.* A credit union shall file a written net worth restoration plan (NWRP) with the appropriate Regional Director and, if state-chartered, the appropriate state official, within 45 calendar days of the effective date of classification as either undercapitalized, significantly undercapitalized or critically undercapitalized, unless the NCUA Board notifies the credit union in writing that its NWRP is to be filed within a different period.

(2) *Exception.* An otherwise adequately capitalized credit union that is reclassified undercapitalized on safety and soundness grounds under § 702.102(b) is not required to submit a NWRP solely due to the reclassification, unless the NCUA Board notifies the credit union that it must submit an NWRP.

(3) *Filing of additional plan.* Notwithstanding paragraph (a)(1) of this section, a credit union that has already submitted and is operating under a NWRP approved under this section is not required to submit an additional NWRP due to a change in net worth category (including by reclassification under § 702.102(b)), unless the NCUA Board notifies the credit union that it must submit a new NWRP. A credit union that is notified to submit a new or revised NWRP shall file the NWRP in writing with the appropriate Regional Director within 30 calendar days of receiving such notice, unless the NCUA Board notifies the credit union in writing that the NWRP is to be filed within a different period.

(4) *Failure to timely file plan.* When a credit union fails to timely file an NWRP pursuant to this paragraph, the NCUA Board shall promptly notify the credit union that it has failed to file an NWRP and that it has 15 calendar days from receipt of that notice within which to file an NWRP.

(b) *Assistance to small credit unions.* Upon timely request by a credit union having total assets of less than $10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing an NWRP required to be filed under paragraph (a) of this section.

(c) *Contents of NWRP.* An NWRP must—

(1) Specify—

(i) A quarterly timetable of steps the credit union will take to increase its net worth ratio, and risk-based capital ratio if applicable, so that it becomes adequately capitalized by the end of the term of the NWRP, and to remain so for four (4) consecutive calendar quarters. If "complex," the credit union is subject to a risk-based net worth requirement that may require a net worth ratio higher than six percent (6%) to become adequately capitalized;

(ii) The projected amount of net worth increases in each quarter of the term of the NWRP as required under § 702.106(a), or as permitted under § 702.106(b);

(iii) How the credit union will comply with the mandatory and any discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(iv) The types and levels of activities in which the credit union will engage; and

(v) If reclassified to a lower category under § 702.102(b), the steps the credit union will take to correct the unsafe or unsound practice(s) or condition(s);

(2) Include pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years; and

(3) Contain such other information as the NCUA Board has required.

(d) *Criteria for approval of NWRP.* The NCUA Board shall not accept a NWRP plan unless it—

(1) Complies with paragraph (c) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in restoring the credit union's net worth; and

(3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(e) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become adequately capitalized, the NCUA Board shall, in evaluating an NWRP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by state law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(f) *Review of NWRP*—(1) *Notice of decision.* Within 45 calendar days after receiving an NWRP under this part, the NCUA Board shall notify the credit union in writing whether the NWRP has been approved, and shall provide reasons for its decision in the event of disapproval.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (f)(1) of this section, the NWRP is deemed approved.

(3) *Consultation with state officials.* In the case of an NWRP submitted by a federally insured state-chartered credit union (whether an original, new, additional, revised or amended NWRP), the NCUA Board shall, when evaluating the NWRP, seek and consider the views of the appropriate state official, and provide prompt notice of its decision to the appropriate state official.

(g) *NWRP not approved*—(1) *Submission of revised NWRP.* If an NWRP is rejected by the NCUA Board, the credit union shall submit a revised NWRP within 30 calendar days of receiving notice of disapproval, unless it is notified in writing by the NCUA Board that the revised NWRP is to be filed within a different period.

(2) *Notice of decision on revised NWRP.* Within 30 calendar days after receiving a revised NWRP under paragraph (g)(1) of this section, the NCUA Board shall notify the credit union in writing whether the revised NWRP is approved. The Board may extend the time within which notice of its decision shall be provided.

(3) *Disapproval of reclassified credit union's NWRP.* A credit union which has been classified significantly undercapitalized shall remain so classified pending NCUA Board approval of a new or revised NWRP.

(4) *Submission of multiple unapproved NWRPs.* The submission of more than two NWRPs that are not approved is considered an unsafe and unsound condition and may subject the credit union to administrative enforcement actions under section 206 of the FCUA, 12 U.S.C. 1786 and 1790d.

(h) *Amendment of NWRP.* A credit union that is operating under an approved NWRP may, after prior written notice to, and approval by the NCUA Board, amend its NWRP to reflect a change in circumstance. Pending approval of an amended NWRP, the credit union shall implement the NWRP as originally approved.

(i) *Publication.* An NWRP need not be published to be enforceable because publication would be contrary to the public interest.

(j) *Termination of NWRP.* For purposes of this part, an NWRP terminates once the credit union is classified as adequately capitalized and remains so for four consecutive quarters. For example, if a credit union with an active NWRP attains the classification as adequately classified on December 31, 2015 this would be quarter one and the fourth consecutive quarter would end September 30, 2016.

§ 702.112 Reserves.

Each credit union shall establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate state official.

§ 702.113 Full and fair disclosure of financial condition.

(a) *Full and fair disclosure defined.* "Full and fair disclosure" is the level of disclosure which a prudent person would provide to a member of a credit union, to NCUA, or, at the discretion of the board of directors, to creditors to fairly inform them of the financial condition and the results of operations of the credit union.

(b) *Full and fair disclosure implemented.* The financial statements of a credit union shall provide for full and fair disclosure of all assets, liabilities, and members' equity, including such valuation (allowance) accounts as may be necessary to present fairly the financial condition; and all income and expenses necessary to present fairly the statement of income for the reporting period.

(c) *Declaration of officials.* The Statement of Financial Condition, when presented to members, to creditors or to NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter's absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered.

(d) *Charges for loan losses.* Full and fair disclosure demands that a credit union properly address charges for loan losses as follows:

(1) Charges for loan losses shall be made in accordance with GAAP;

(2) The ALLL established for loans must fairly present the probable losses for all categories of loans and the proper valuation of loans. The valuation allowance must encompass specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses have been incurred but are not identifiable on a specific loan-by-loan basis;

(3) Adjustments to the valuation ALLL will be recorded in the expense account "Provision for Loan and Lease Losses"; and

(4) At a minimum, adjustments to the ALLL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.114 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from net worth, if any.

(b) *Payment of dividends if retained earnings depleted.* The board of directors of a well capitalized credit union that has depleted the balance of its retained earnings may authorize dividend payments, provided that either—

(1) The payment of dividends will not cause the credit union's net worth classification to fall below adequately capitalized under subpart A of this part; or

(2) If the payment of dividends will cause the net worth classification to fall below adequately capitalized, the appropriate Regional Director and, if state-chartered, the appropriate state official, have given prior written approval (in an NWRP or otherwise) to pay a dividend. The request for written approval must include the plan for eliminating any negative retained earnings balance.

(c) *Restriction on payment of dividends if, after payment of dividends, the credit union's net worth ratio would be less than 6 percent.* If, after payment of a dividend or refund of interest, a well capitalized credit union's net worth ratio would fall below 6 percent in the current quarter, the board of directors of the credit union may not:

(1) Declare a dividend at a rate that is higher than the prevailing rates paid on comparable accounts and maturities in the relevant market area;

(2) Declare a non-repetitive dividend; or

(3) Authorize a refund of interest.

Subpart B—Alternative Prompt Corrective Action for New Credit Unions

§ 702.201 Scope and definition.

(a) *Scope.* This subpart B applies in lieu of subpart A of this part exclusively to credit unions defined in paragraph (b) of this section as "new" pursuant to section 216(b)(2) of the FCUA, 12 U.S.C. 1790d(b)(2).

(b) *New credit union defined.* A "new" credit union for purposes of this subpart is a credit union that both has been in operation for less than ten (10) years and has total assets of not more than $10 million. Once a credit union reports total assets of more than $10 million on a Call Report, the credit union is no longer new, even if its assets subsequently decline below $10 million.

(c) *Effect of spin-offs.* A credit union formed as the result of a "spin-off" of a group from the field of membership of an existing credit union is deemed to be in operation since the effective date of the spin-off. A credit union whose total assets decline below $10 million because a group within its field of membership has been spun-off is deemed "new" if it has been in operation less than 10 years.

(d) *Actions to evade prompt corrective action.* If the NCUA Board determines that a credit union was formed, or was reduced in asset size as a result of a spin-off, or was merged, primarily to qualify as "new" under this subpart, the credit union shall be deemed subject to prompt corrective action under subpart A of this part.

§ 702.202 Net worth categories for new credit unions.

(a) *Net worth measures.* For purposes of this part, a new credit union must determine its capital classification quarterly according to its net worth ratio.

(b) *Effective date of net worth classification of new credit union.* For purposes of subpart B of this part, the effective date of a new credit union's classification within a capital category in paragraph (c) of this section shall be determined as provided in § 702.101(b); and written notice to the NCUA Board of a decline in net worth classification in paragraph (c) of this section shall be given as required by § 702.101(c).

(c) *Net worth categories.* A credit union defined as "new" under this section shall be classified (Table 1 of this section)—

(1) *Well capitalized* if it has a net worth ratio of seven percent (7%) or greater;

(2) *Adequately capitalized* if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%);

(3) *Moderately capitalized* if it has a net worth ratio of three and one-half percent (3.5%) or more but less than six percent (6%);

(4) *Marginally capitalized* if it has a net worth ratio of two percent (2%) or more but less than three and one-half percent (3.5%);

(5) *Minimally capitalized* if it has a net worth ratio of zero percent (0%) or greater but less than two percent (2%); and

(6) *Uncapitalized* if it has a net worth ratio of less than zero percent (0%) (*e.g.*, a deficit in retained earnings).

TABLE 1 TO § 702.202—CAPITAL CATEGORIES FOR NEW CREDIT UNIONS

A new credit union's capital classification is . . .	If it's net worth ratio is . . .
Well Capitalized	7% or above.
Adequately Capitalized	6 to 7%.
Moderately Capitalized	3.5% to 5.99%.
Marginally Capitalized	2% to 3.49%.
Minimally Capitalized	0% to 1.99%.
Uncapitalized	Less than 0%.

(d) *Reclassification based on supervisory criteria other than net worth.* Subject to § 702.102(b), the NCUA Board may reclassify a well capitalized, adequately capitalized or moderately capitalized new credit union to the next lower capital category (each of such actions is hereinafter referred to generally as "reclassification") in either of the circumstances prescribed in § 702.102(b).

(e) *Consultation with state officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before reclassifying a federally insured state-chartered credit union under paragraph (d) of this section, and shall promptly notify the appropriate state official of its decision to reclassify.

§ 702.203 Prompt corrective action for adequately capitalized new credit unions.

Beginning on the effective date of classification, an adequately capitalized new credit union must increase the dollar amount of its net worth by the amount reflected in its approved initial or revised business plan in accordance with § 702.204(a)(2), or in the absence of such a plan, in accordance with § 702.106 until it is well capitalized.

§ 702.204 Prompt corrective action for moderately capitalized, marginally capitalized, or minimally capitalized new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the date of classification as moderately capitalized, marginally capitalized or minimally capitalized (including by reclassification under § 702.202(d)), a new credit union must—

(1) *Earnings retention.* Increase the dollar amount of its net worth by the amount reflected in its approved initial or revised business plan;

(2) *Submit revised business plan.* Submit a revised business plan within the time provided by § 702.206 if the credit union either:

(i) Has not increased its net worth ratio consistent with its then-present approved business plan;

(ii) Has no then-present approved business plan; or

(iii) Has failed to comply with paragraph (a)(3) of this section; and

(3) *Restrict member business loans.* Not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end unless it is granted an exception under 12 U.S.C. 1757a(b).

(b) *Discretionary supervisory actions by NCUA.* Subject to the applicable procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.109(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Discretionary conservatorship or liquidation.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board may place a new credit union which is moderately capitalized, marginally capitalized or minimally capitalized (including by reclassification under § 702.202(d)) into conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(i), provided that the credit union has no reasonable prospect of becoming adequately capitalized.

§ 702.205 Prompt corrective action for uncapitalized new credit unions.

(a) *Mandatory supervisory actions by new credit union.* Beginning on the effective date of classification as uncapitalized, a new credit union must—

(1) *Earnings retention.* Increase the dollar amount of its net worth by the amount reflected in the credit union's approved initial or revised business plan;

(2) *Submit revised business plan.* Submit a revised business plan within the time provided by § 702.206, providing for alternative means of funding the credit union's earnings deficit, if the credit union either:

(i) Has not increased its net worth ratio consistent with its then-present approved business plan;

(ii) Has no then-present approved business plan; or

(iii) Has failed to comply with paragraph (a)(3) of this section; and

(3) *Restrict member business loans.* Not increase the total dollar amount of member business loans as provided in § 702.204(a)(3).

(b) *Discretionary supervisory actions by NCUA.* Subject to the procedures set forth in subpart L of part 747 of this chapter for issuing, reviewing and enforcing directives, the NCUA Board may, by directive, take one or more of the actions prescribed in § 702.109(b) if the credit union's net worth ratio has not increased consistent with its then-present business plan, or the credit union has failed to undertake any mandatory supervisory action prescribed in paragraph (a) of this section.

(c) *Mandatory liquidation or conservatorship.* Notwithstanding any other actions required or permitted to be taken under this section, the NCUA Board—

(1) *Plan not submitted.* May place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an uncapitalized new credit union which fails to submit a revised business plan within the time provided under paragraph (a)(2) of this section; or

(2) *Plan rejected, approved, implemented.* Except as provided in paragraph (c)(3) of this section, must place into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A)(ii), or conservatorship pursuant to 12 U.S.C. 1786(h)(1)(F), an uncapitalized new credit union that remains uncapitalized one hundred twenty (120) calendar days after the later of:

(i) The effective date of classification as uncapitalized; or

(ii) The last day of the calendar month following expiration of the time period provided in the credit union's initial business plan (approved at the time its charter was granted) to remain uncapitalized, regardless whether a revised business plan was rejected, approved or implemented.

(3) *Exception.* The NCUA Board may decline to place a new credit union into liquidation or conservatorship as provided in paragraph (c)(2) of this section if the credit union documents to the NCUA Board why it is viable and has a reasonable prospect of becoming adequately capitalized.

(d) *Mandatory liquidation of uncapitalized federal credit union.* In lieu of paragraph (c) of this section, an uncapitalized federal credit union may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

§ 702.206 Revised business plans (RBP) for new credit unions.

(a) *Schedule for filing*—(1) *Generally.* Except as provided in paragraph (a)(2) of this section, a new credit union classified moderately capitalized or lower must file a written revised business plan (RBP) with the appropriate Regional Director and, if state-chartered, with the appropriate state official, within 30 calendar days of either:

(i) The last of the calendar month following the end of the calendar quarter that the credit union's net worth ratio has not increased consistent with its the-present approved business plan;

(ii) The effective date of classification as less than adequately capitalized if the credit union has no then-present approved business plan; or

(iii) The effective date of classification as less than adequately capitalized if the credit union has increased the total amount of member business loans in violation of § 702.204(a)(3).

(2) *Exception.* The NCUA Board may notify the credit union in writing that its RBP is to be filed within a different period or that it is not necessary to file an RBP.

(3) *Failure to timely file plan.* When a new credit union fails to file an RBP as provided under paragraphs (a)(1) or (a)(2) of this section, the NCUA Board shall promptly notify the credit union that it has failed to file an RBP and that it has 15 calendar days from receipt of that notice within which to do so.

(b) *Contents of revised business plan.* A new credit union's RBP must, at a minimum—

(1) Address changes, since the new credit union's current business plan was approved, in any of the business plan elements required for charter approval under chapter 1, section IV.D, of appendix B to part 701 of this chapter, or for state-chartered credit unions under applicable state law;

(2) Establish a timetable of quarterly targets for net worth during each year in which the RBP is in effect so that the credit union becomes adequately capitalized by the time it no longer qualifies as "new" per § 702.201(b);

(3) Specify the projected amount of earnings of net worth increases as provided under § 702.204(a)(1) or 702.205(a)(1);

(4) Explain how the new credit union will comply with the mandatory and discretionary supervisory actions imposed on it by the NCUA Board under this subpart;

(5) Specify the types and levels of activities in which the new credit union will engage;

(6) In the case of a new credit union reclassified to a lower category under § 702.202(d), specify the steps the credit union will take to correct the unsafe or unsound condition or practice; and

(7) Include such other information as the NCUA Board may require.

(c) *Criteria for approval.* The NCUA Board shall not approve a new credit union's RBP unless it—

(1) Addresses the items enumerated in paragraph (b) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in building the credit union's net worth; and

(3) Would not unreasonably increase the credit union's exposure to risk (including credit risk, interest-rate risk, and other types of risk).

(d) *Consideration of regulatory capital.* To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become adequately capitalized, the NCUA Board shall, in evaluating an RBP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by state law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

(e) *Review of revised business plan*—(1) *Notice of decision.* Within 30 calendar days after receiving an RBP under this section, the NCUA Board shall notify the credit union in writing whether its RBP is approved, and shall provide reasons for its decision in the event of disapproval. The NCUA Board may extend the time within which notice of its decision shall be provided.

(2) *Delayed decision.* If no decision is made within the time prescribed in paragraph (e)(1) of this section, the RBP is deemed approved.

(3) *Consultation with state officials.* When evaluating an RBP submitted by a federally insured state-chartered new credit union (whether an original, new or additional RBP), the NCUA Board shall seek and consider the views of the appropriate state official, and provide prompt notice of its decision to the appropriate state official.

(f) *Plan not approved*—(1) *Submission of new revised plan.* If an RBP is rejected by the NCUA Board, the new credit union shall submit a new RBP within 30 calendar days of receiving notice of disapproval of its initial RBP, unless it is notified in writing by the NCUA Board that the new RBP is to be filed within a different period.

(2) *Notice of decision on revised plan.* Within 30 calendar days after receiving an RBP under paragraph (f)(1) of this section, the NCUA Board shall notify the credit union in writing whether the new RBP is approved. The Board may extend the time within which notice of its decision shall be provided.

(3) *Submission of multiple unapproved RBPs.* The submission of more than two RBPs that are not approved is considered an unsafe and

unsound condition and may subject the credit union to administrative enforcement action pursuant to section 206 of the FCUA, 12 U.S.C. 1786 and 1790d.

(g) *Amendment of plan.* A credit union that has filed an approved RBP may, after prior written notice to and approval by the NCUA Board, amend it to reflect a change in circumstance. Pending approval of an amended RBP, the new credit union shall implement its existing RBP as originally approved.

(h) *Publication.* An RBP need not be published to be enforceable because publication would be contrary to the public interest.

§ 702.207 Incentives for new credit unions.

(a) *Assistance in revising business plans.* Upon timely request by a credit union having total assets of less than $10 million (regardless how long it has been in operation), the NCUA Board shall provide assistance in preparing a revised business plan required to be filed under § 702.206.

(b) *Assistance.* Management training and other assistance to new credit unions will be provided in accordance with policies approved by the NCUA Board.

(c) *Small credit union program.* A new credit union is eligible to join and receive comprehensive benefits and assistance under NCUA's Small Credit Union Program.

§ 702.208 Reserves.

Each new credit union shall establish and maintain such reserves as may be required by the FCUA, by state law, by regulation, or in special cases by the NCUA Board or appropriate state official.

§ 702.209 Full and fair disclosure of financial condition.

(a) *Full and fair disclosure defined.* "Full and fair disclosure" is the level of disclosure which a prudent person would provide to a member of a new credit union, to NCUA, or, at the discretion of the board of directors, to creditors to fairly inform them of the financial condition and the results of operations of the credit union.

(b) *Full and fair disclosure implemented.* The financial statements of a new credit union shall provide for full and fair disclosure of all assets, liabilities, and members' equity, including such valuation (allowance) accounts as may be necessary to present fairly the financial condition; and all income and expenses necessary to present fairly the statement of income for the reporting period.

(c) *Declaration of officials.* The Statement of Financial Condition, when presented to members, to creditors or to NCUA, shall contain a dual declaration by the treasurer and the chief executive officer, or in the latter's absence, by any other officer designated by the board of directors of the reporting credit union to make such declaration, that the report and related financial statements are true and correct to the best of their knowledge and belief and present fairly the financial condition and the statement of income for the period covered.

(d) *Charges for loan losses.* Full and fair disclosure demands that a new credit union properly address charges for loan losses as follows:

(1) Charges for loan losses shall be made in accordance with generally accepted accounting principles (GAAP);

(2) The allowance for loan and lease losses (ALL) established for loans must fairly present the probable losses for all categories of loans and the proper valuation of loans. The valuation allowance must encompass specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses have been incurred but are not identifiable on a specific loan-by-loan basis;

(3) Adjustments to the valuation ALL will be recorded in the expense account "Provision for Loan and Lease Losses; and

(4) At a minimum, adjustments to the ALL shall be made prior to the distribution or posting of any dividend to the accounts of members.

§ 702.210 Payment of dividends.

(a) *Restriction on dividends.* Dividends shall be available only from net worth, if any.

(b) *Payment of dividends if retained earnings depleted.* The board of directors of a well capitalized new credit union that has depleted the balance of its retained earnings may authorize dividend payments, provided that either—

(1) The payment of dividends will not cause the credit union's net worth classification to fall below adequately capitalized under subpart B of this part; or

(2) If the payment of dividends will cause the net worth classification to fall below adequately capitalized, the appropriate Regional Director and, if state-chartered, the appropriate state official, have given prior written approval (in an NWRP or otherwise) to pay a dividend. The request for written approval must include the plan for eliminating any negative retained earnings balance.

(c) *Restriction on payment of dividends if, after payment of dividends, the new credit union's net worth ratio would be less than 6 percent.* If, after payment of a dividend or refund of interest, a well capitalized new credit union's net worth ratio would fall below 6 percent in the current quarter, the board of directors of the new credit union may not:

(1) Declare a dividend at a rate that is higher than the prevailing rates paid on comparable accounts and maturities in the relevant market area;

(2) Declare a non-repetitive dividend; or

(3) Authorize a refund of interest.

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

■ 9. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

§ 703.14 [Amended]

■ 10. Amend § 703.14 as follows:

■ a. In paragraph (i) remove the words "net worth classification" and add in their place the words "capital classification", and remove the words "or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement,".

■ b. In paragraph (j)(4) remove the words "net worth classification" and add in their place the words "capital classification", and remove the words "or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement,".

PART 713—FIDELITY BOND AND INSURANCE COVERAGE FOR FEDERAL CREDIT UNIONS

■ 11. The authority citation for part 713 continues to read as follows:

Authority: 12 U.S.C. 1761a, 1761b, 1766(a), 1766(h), 1789(a)(11).

■ 12. Amend § 713.6 as follows:

■ a. In paragraph (a)(1), revise the table; and

■ b. In paragraph (c) remove the words "net worth" each place they appear and add in their place the word "capital", and remove the words "or, if subject to a risk-based net worth (RBNW) requirement under part 702 of this chapter, has remained 'well capitalized' for the six (6) immediately preceding quarters after applying the applicable RBNW requirement,".

§ 713.6 What is the permissible deductible?

(a)(1) * * *

Assets	Maximum deductible
$0 to $100,000	No deductible allowed.
$100,001 to $250,000	$1,000.
$250,000 to $1,000,000	$2,000.
Over $1,000,000	$2,000 plus 1/1000 of total assets up to a maximum of $200,000; for credit unions that have received a composite CAMEL rating of "1" or "2" for the last two (2) full examinations and maintained a capital classification of "well capitalized" under part 702 of this chapter for the six (6) immediately preceding quarters the maximum deductible is $1,000,000.

* * * * *

PART 723—MEMBER BUSINESS LOANS

■ 13. The authority citation for part 723 continues to read as follows:

Authority: 12 U.S.C. 1756, 1757, 1757A, 1766, 1785, 1789.

§ 723.7 [Amended]

■ 14. Amend § 723.7(c)(1) by removing the words "as defined by § 702.102(a)(1)" and adding in their place the words "under part 702".

PART 747—ADMINISTRATIVE ACTIONS, ADJUDICATIVE HEARINGS, RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS

■ 15. The authority citation for part 747 continues to read as follows:

Authority: 12 U.S.C. 1766, 1782, 1784, 1785, 1786, 1787, 1790a, 1790d; 42 U.S.C. 4012a; Pub. L. 101–410; Pub. L. 104–134; Pub. L. 109–351; 120 Stat. 1966.

§ 747.2001 [Amended]

■ 16. Amend § 747.2001(a) by removing the citation "702.302(d)" and adding in its place the citation "702.202(d)".

§ 747.2002 [Amended]

■ 17. Amend § 747.2002(a) by removing the words "§§ 702.202(b), 702.203(b) and 702.204(b)" and adding in their place the words "§§ 702.107(b), 702.108(b), or 702.109(b)", and by removing the words "§§ 702.304(b) or 702.305(b)" and adding in their place the words "§§ 702.204(b) or 702.205(b)".

§ 747.2003 [Amended]

■ 18. Amend § 747.2003(a) by removing the citation "702.302(d)" and adding in its place the citation "702.202(d)".

■ 19. Add § 747.2006 to subpart L to read as follows:

§ 747.2006. Review of order imposing individual minimum capital requirements (IMCR).

(a) *Notice of proposed individual minimum capital requirements.* When NCUA proposes to impose individualized minimal capital requirements for a particular credit union pursuant to § 702.105 of this chapter (each such action hereinafter referred to as an "IMCR"), NCUA shall issue and serve on the credit union reasonable prior notice of the proposed IMCR. NCUA shall also forward a copy of the notifying letter to the appropriate state supervisory authority (SSA) if a state-chartered corporate credit union would be subject to an IMCR.

(b) *Contents of the Notice.* A notice of intention to impose an IMCR for a credit union based on particular capital conditions at a credit union shall state the following:

(1) The credit union's net worth ratio, risk-based capital ratio and net worth classification.

(2) The specific minimum capital levels that the NCUA Board intends to impose on the credit union under the IMCR, and the specific causes for determining that the higher IMCR is necessary or appropriate for the credit union.

(3) The proposed schedule for compliance with the new requirement.

(4) That the credit union must file a written response to the notice, which shall be due no less than 30 calendar days from the date of service of the notice. The NCUA Board may extend the time period for good cause, and the time period for response by the insured credit union may be shortened for good cause:

(i) When, in the opinion of NCUA, the condition of the credit union so requires, and NCUA informs the credit union of the shortened response period in the notice; or

(ii) With the consent of the credit union.

(c) *Contents of response to notice.* A credit union's response to a notice under paragraph (b) of this section must include:

(1) An explanation of why it contends the IMCR is not an appropriate exercise of discretion under this part;

(2) A request that the NCUA Board modify or not issue the IMCR;

(3) Any information, mitigating circumstances, documentation, or other evidence in support of the credit union's position that the credit union wants NCUA to consider in deciding whether to establish or to amend an IMCR for the credit union; and

(4) If desired, a request for a recommendation from the NCUA's Ombudsman pursuant to paragraph (g) of this section.

(d) *Failure to file response.* Failure by the credit union to respond within 30 days, or such other time period as may be specified by NCUA, may constitute a waiver of any objections to the proposed IMCR or to the schedule for complying with it, unless NCUA has provided an extension of the response period for good cause.

(e) *Final decision by NCUA.* After expiration of the response period, NCUA will decide whether or not the proposed IMCR should be established for the credit union, or whether that proposed requirement should be adopted in modified form, based on a review of the credit union's response and other relevant information. NCUA's decision will address comments received within the response period from the credit union and the appropriate state supervisory authority (SSA) (in the case of a state-chartered credit union) and will state the level of capital required, the schedule for compliance with this requirement, and any specific remedial action the credit union could take to eliminate the need for continued applicability of the IMCR. NCUA will provide the credit union and the appropriate SSA (if a state-chartered credit union is involved) with a written decision on the IMCR, addressing the substantive comments made by the credit union and setting forth the decision and the basis for that decision. Upon receipt of this decision by the credit union, the IMCR becomes effective and binding upon the credit union. This decision represents final agency action.

(f) *Request to modify or rescind IMCR.* A credit union that is subject to an existing IMCR may request in writing that the NCUA Board reconsider the

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terms of the IMCR due to changed circumstances. Unless otherwise ordered by the NCUA Board, the IMCR shall remain in effect while such request is pending. A request under this paragraph (f) that remains pending 60 days following receipt by the NCUA Board is deemed granted.

(g) *Ombudsman.* A credit union may request in writing the recommendation of NCUA's ombudsman to modify or to not issue a proposed IMCR under paragraph (b) of this section, or to modify or rescind an existing IMCR due to changed circumstances under paragraph (f) of this section. A credit union which fails to request the ombudsman's recommendation in a response under paragraph (c) of this section, or in a request under paragraph (f) of this section, shall be deemed to have waived the opportunity to do so. The ombudsman shall promptly notify the credit union and the NCUA Board of his or her recommendation.

[FR Doc. 2014–01702 Filed 2–26–14; 8:45 am]

BILLING CODE 7535–01–P

Fact Sheet: National Credit Union Administration Budget Process

Overview

The National Credit Union Administration (NCUA) is committed to integrating strategic and annual planning into its budget formulation process. Through the integration, the NCUA Board ensures that resources are aligned to the agency's highest priorities.

Each summer, under the leadership of the NCUA Chief Financial Officer (CFO), NCUA develops its budget using zero-based budgeting techniques, which ensure each activity is individually justified to the Board in order to be considered for funding. Under this process, the budget for each office is rigorously evaluated to ensure NCUA resources are allocated efficiently and priority needs are funded, regardless of the prior year funding level. NCUA requires each office to explain the merits of every line item, the specific needs for each category of spending, and the basis of developing each cost estimate.

After receiving the proposed budget for each NCUA office, the Chief Financial Officer and Executive Director meet individually with Office Directors and Regional Directors so that each budget and budget line item can be explained, justified, and reviewed.

As the budget formulation process is iterative, refinements are continually made, resulting in rolling adjustments to the budget proposal. During the budget development process, the Executive Director and Chief Financial Officer brief the Chairman and each Board Member multiple times on the budget proposals submitted, updated, and recommended. In addition, analytical and summary information is also prepared to provide for comparison to prior years and to highlight material increases or decreases to budget items.

Budget Development

Given the nature of NCUA's mission and strategic plan goals and objectives, funding to support staffing levels is the single largest budget category.

In developing the budget proposal, the examination and supervision workload is estimated to determine the number of staff hours necessary to carry out NCUA's dual mission as insurer and regulator. The workload analysis is a bottom-up process with the field staff reviewing the condition and supervision needs for each credit union and recommending the hours for each. The estimates are refined by management in the field program until the final budget proposal is completed.

The workload analysis establishes the foundation for the Office of National Examinations and Supervision and the five regional budget requests, which represent over 72 percent of NCUA personnel. Based on the workload analysis, NCUA determines the staffing levels and requisite personnel compensation and benefits required to support the workload hours.

In addition, all 21 NCUA offices develop a bottom-up resource request. Each position must be validated and updated with the requisite personnel information to accurately project salary and benefit costs with the approved merit, locality and other inflationary adjustments such as health care costs. Any new resource requirements supporting a new position are presented and defended by the applicable Office Director to the Executive Director and Chief Financial Officer.

When the Executive Director and Chief Financial Officer complete their analysis of requested positions, their analysis is presented in detailed briefings to each Board Member for their consideration. Where possible, the Board makes every effort to curtail any net addition of full-time equivalent positions, by use of attrition and strategic allocation of resources. After evaluating all alternatives, the Board ultimately determines whether any new net FTE positions are warranted.

Other specific estimation procedures include:

- Travel requirements for all examination program staff are identified and justified based on workload analysis, meeting and conference plans, and individual development plans.

- Rent, communication and utility expenses are reviewed for valid operational recurring requirements. Historical spending is used to assist in calculating the out-year costs; however, all costs are examined and estimated. NCUA staff also examine for cost savings. Examples of cost reductions that can be identified include efficiency savings associated with utilities, postage savings or lease renegotiations.

- Administrative expenses are reviewed for valid operational recurring requirements. Historical spending is used to assist in calculating the out-year costs, and all costs are examined and estimated. Costs for 2015 include large recurring expenses such as software licenses and maintenance fees, depreciation expense, laptop computer leases, and mandatory expenses such as Federal Financial Institutions Examination Council fees.

- Contract expenses, which include a variety of projects, are assessed based on priority requirements as determined by the agency's strategic plan and statutory requirements. Annual project reviews are conducted to ensure plans are consistent with the goals and objectives in NCUA's Strategic Plan. In addition, contract spending associated with software development is prioritized by NCUA's Information Technology Priority Council.

National Credit Union Administration

BOARD ACTION MEMORANDUM

TO: NCUA Board **DATE:** November 20, 2014

FROM: Office of the Chief Financial Officer **SUBJ:** FY 2015 Budget

ACTION REQUESTED: Board approval of the fiscal year 2015 operating and capital budgets

DATE ACTION REQUESTED: November 20, 2014

OTHER OFFICES CONSULTED: All regional and central office directors and Executive Director

VIEWS OF OTHER OFFICES CONSULTED: Concur

BUDGET IMPACT: $279.5 million and 1,268.7 full-time equivalents (FTE)

SUBMITTED TO INSPECTOR GENERAL FOR REVIEW: Yes

RESPONSIBLE STAFF MEMBERS: Chief Financial Officer Mary Ann Woodson

AUTHORITY: Per the Federal Credit Union Act, the management of the Administration is vested in the National Credit Union Administration (NCUA) Board. It is the Board's responsibility to determine the expenses necessary to carry out its responsibilities under the Act. 12 U.S.C. § 1752a(a). The Board is authorized to expend such funds and perform such other functions or acts as it may deem necessary or appropriate in accordance with the rules and regulations or policies established by the Board. § 1766(i)(2)

Upon determination of the budgeted expenses, the Board determines a fee schedule with respect to federal credit unions, giving consideration to the expenses of the Administration in carrying out its responsibilities in connection with federal credit unions and the ability of federal credit unions to pay a fee. § 1755(a)-(b). That fee schedule is documented in the separate operating fee assessment Board Action Memorandum (BAM). Fees collected are required to be deposited with the Treasurer of the United States for the account of the Administration, and expended by the Board to defray the expenses incurred in carrying out the agency's operations, including the examination and supervision of federal credit unions. § 1755(d). Via the Overhead Transfer Rate, which is documented in the a separate BAM, the Board transfers additional National Credit Union Share Insurance Fund (NCUSIF) money to its operating fund to account for budgeted expenses related to both federal credit unions and federally insured, state-chartered credit unions, in accordance with its authority to use the Share Insurance Fund to carry out its responsibilities. § 1783(a)

At the end of the calendar year, NCUA's financial transactions are subject to audit in accordance with Generally Accepted Accounting Principles. §§ 1783(b) & 1789(b).

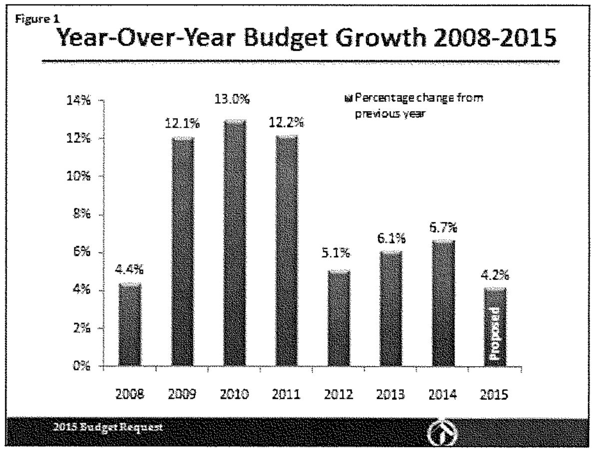
BACKGROUND: This memorandum recommends that the NCUA Board approve the proposed 2015 budget of $279,477,779 and 1,268.7 full-time equivalents (FTE). NCUA's budget process uses the agency's strategic goals and objectives set forth in the *NCUA Strategic Plan 2014 through 2017* as a framework to ensure agency priorities and initiatives drive resulting resources needs and allocations. The annual budget provides the resources to execute against the strategic plan and undertake tasks in NCUA's major programs: examination and supervision, insurance, small credit union initiatives, consumer protection, and asset management. The Strategic Plan also identifies the NCUA's goals and objectives including the following priorities: manage operational vulnerabilities by implementing a robust supervision framework for financial reform regulations, including interest rate risk and stress testing; prepare for and promote awareness of critical risk issues and related threats such as cybersecurity risks; develop and promote financial literacy education and consumer protection programs; develop and communicate guidance to credit unions to explain regulatory changes and best practices; and, strengthen security programs and communications.

Each regional and central office director developed a budget request identifying resources required to support NCUA's mission and strategic goals and objectives. These budgets were developed using zero-based budgeting techniques to ensure each office's requirements were individually justified and consistent with the agency's overall strategic plan. One of the primary inputs in the development process is a comprehensive workload analysis that captures the amount of time necessary to conduct examinations and supervision of federally insured credit unions in order to carry out NCUA's dual mission as insurer and regulator. This process starts with a field level review of every credit union to determine the number of workload hours needed for the current year. The workload estimates are refined by each level of management in the field program until the final budget proposal is completed and forwarded to the central office for review and analysis. The final workload analysis establishes the foundation for the NCUA's five regional office budget requests and for the Office of National Examinations and Supervision (ONES), representing 72 percent of NCUA personnel. In addition to the workload analysis, which is used to develop personnel and travel costs, all offices developed cost estimates for fixed and recurring items such as rent or leased property, operations and maintenance, repair on owned facilities, supplies, telecommunications, and other administrative and contracted services costs.

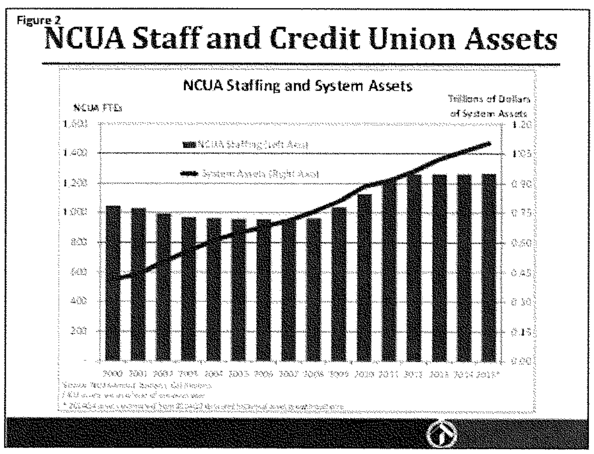
All office budget submissions within NCUA underwent thorough reviews by the responsible regional and central office directors, the Chief Financial Officer, and executive leadership. NCUA's Information Technology Prioritization Council (ITPC) met with every regional and central office to review and prioritize software initiatives and align those information technology (IT) investments with NCUA's mission. These multi-level reviews result in a mutually agreed-upon budget to support NCUA's top priorities: implementing a robust supervision framework, promoting awareness of critical risks and related threats, developing financial literacy and consumer protection programs, providing guidance to credit unions, and strengthening security programs.

For reporting purposes and comparability with the practices of other Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) agencies, comparisons to last year's approved budget are included in this document. A summary description of the major spending items in each budget category is included to provide improved transparency and understanding of how the budget resources will be used. Further, NCUA will provide supporting documentation for this request on the NCUA website to assist the public in understanding its budget development process.

SUMMARY: The proposed 2015 budget of **$279,477,779** represents an increase of **4.2 percent** or **$11,187,483 over** the 2014 budget of $268,290,296. This is the smallest percentage increase since 2008. The budget increase reflects necessary expenditures to ensure successful execution of the agency's mission and strategic plan.



The 2015 budget proposes a modest net increase to authorized staffing levels. The 2015 Full Time Equivalent (FTE) level is increased to a new authorized level of **1,268.7**. This includes a net increase of 4.2 FTEs from the 2014 mid-session budget. As seen in Figure 2, NCUA staffing growth continues to remain well below credit union asset growth[1].



[1] Source data: NCUA Annual Budget, Call Reports. FICU assets for 2015 are estimated.

Attachment 1 shows the breakout of the proposed 2015 budget by office.

The components of the 2015 budget as compared to the 2014 budget are:

Category	2014 Budget	**2015 Budget**	$ Change	Percent Change	Percent of Total Budget
Employee Pay and Benefits	$ 194,632,214	**$ 201,895,097**	$ 7,262,883	3.7%	72%
Travel	28,514,578	**29,288,793**	774,215	2.7%	11%
Rent, Communications & Utilities	5,615,191	**5,772,087**	156,896	2.8%	2%
Administrative	15,393,236	**16,334,758**	941,522	6.1%	6%
Contracted Services	24,135,077	**26,187,044**	2,051,967	8.5%	9%
Total	$ 268,290,296	**$ 279,477,779**	$ 11,187,483	4.2%	100%

SIGNIFICANT BUDGETARY CHANGES:

Staffing Changes:

NCUA's top two priorities, consistent with an evolving credit union industry, are to: 1) maintain a robust supervision framework and 2) promote awareness of critical risks and related threats. This includes identifying and resolving traditional risk concerns such as interest rate risk, credit risk and concentration risk, as well as new and evolving operational risks including cybersecurity threats. To address these priorities and risk concerns, the budget proposes to reallocate 18 existing regional staff from generalist positions to the priority areas of capital markets, lending, and information systems. Employing specialists rather than generalists adds expertise commensurate with the increasing sophistication of credit union operations, so that NCUA will be better equipped to address these risk areas going forward.

In addition to realigning regional resources to priority needs, NCUA's budget proposes to add mission support staff to further support the stated priorities of a robust supervision framework, developing financial literacy and consumer protection programs, providing guidance to credit unions, enhancing cybersecurity and strengthening security programs. Additional staff proposed includes nine new positions as outlined below. This increase is offset by the reduction of five general examiner positions to be eliminated from the regional offices for a net increase of 4.2 FTEs. The new positions, linked to the strategic priorities, include:

1. Supervision – To support NCUA's priority of implementing a robust supervision framework, it is recommended that three new staff positions be added to:

    a. The Office of National Examinations and Supervision (ONES) for a Senior Capital Markets Analyst to support capital planning and stress testing regulations for natural person credit unions with assets over $10 billion. This will focus on large institution risk in relation to the NCUSIF.

b. ONES for an additional Lending Specialist Examiner to serve as an expert to staff during examinations or reviews of credit unions and credit union service organizations with complex lending programs. This position is needed to support the existing cadre of lending personnel.

c. The Office of Chief Economist for an economist position to support the increasing demands for in-depth analytical resources including simulation and modeling to support the examination workforce.

2. Cybersecurity – It is recommended that a cybersecurity manager be added to the Office of Examination and Insurance so the agency can be better prepared for and promote the awareness of critical risks and related threats. This position will help to establish the policy, risk management and communication objectives to support the cybersecurity priorities of NCUA and the interagency initiatives jointly managed with the Federal Financial Institutions Examination Council (FFIEC) to protect the financial services industry.

3. Consumer Protection - It is recommended that the Office of Consumer Protection add two personnel to support NCUA's financial literacy and consumer protection programs.

   a. A new consumer affairs program officer is required to support the accurate and timely processing of consumer inquiries and complaints about credit unions, as well as proactively identify consumer protection concerns. NCUA's Consumer Assistance Center volume has doubled in 2014 over 2013.

   b. A consumer compliance policy and outreach officer is necessary to provide expanded outreach to support NCUA staff and credit union officials on federal financial consumer protection matters.

4. Provide Guidance to Credit Unions – It is recommended the Office of Small Credit Union Initiatives add a staff member responsible for field consultation, automated tools and reports, and the OSCUI web microsite. This will further improve the efficiency and effectiveness of OSCUI so it can deliver timely and more user-friendly products and services to its portfolio of credit unions.

5. Security Programs – It is recommended that to strengthen NCUA's security programs, supporting multiple agency objectives related to security and financial sector threats, the Office of Continuity and Security Management be expanded by two personnel:

   a. A classified information security specialist is required to manage the NCUA sensitive compartmented information facility, ensure compliance with national security requirements for the safeguarding of classified information as mandated by the Director of National Intelligence (DNI), and to oversee the operations and conduct of the secure communications operations and testing in compliance with DNI and National Communications System Directives. This work has become increasingly complex and must adhere to requirements in the National Communications System Directive 3-10 and guidance from DNI.

b. An intelligence specialist with knowledge of both financial sector threats and cyber threats will provide support to NCUA network security and business operations by sharing information on critical infrastructure protection for the credit union sector. The cyber intelligence analysis requires specialized skills that include mastery knowledge of national security threats, cybersecurity, the Intelligence Community, analytical techniques, and applicable regulations, principles, Director of National Intelligence regulations and standards.

Employee Pay and Benefits:

The employee pay and benefits expense category net increase of $7.3 million brings the total 2015 cost of pay and benefits to $201.9 million, a 3.7 percent change, as compared to 2014.

Pay and benefits represent 72 percent of the total budget request. A major driver of the increase is merit and locality pay increases, primarily due to NCUA's current collective bargaining agreement. NCUA's compensation continues to "maintain comparability with other federal bank regulatory agencies" as stipulated in the Federal Credit Union Act[2]. NCUA staff will be eligible to receive an average merit-based increase of four percent and a locality adjustment of up to three percent for most staff. In addition, the cost for the net increase of four new positions proposed is estimated to be $443,000 and assumes these personnel will be on board for only one- half of the year.

In addition, the Office of Personnel Management (OPM) revised the economic assumptions used for actuarial valuation of the Federal Employees Retirement System (FERS). Under the new methodology, for 2015 all federal agencies must contribute 13.2 percent of FERS employees' salary to the retirement system. This is up from 11.9 percent, and is estimated to cost NCUA an additional $1.8 million for a total of $17.9 million in 2015. OPM also announced the government's portion of the Federal Employees Health Benefits program will increase an average of three percent in 2015. The estimated cost of NCUA's health benefits in 2015 are expected to total $12.6 million.

The employee pay and benefits category also includes increased costs associated with promotions, position changes, and other mandatory employer contributions such as social security, retirement, transportation subsidies and worker's compensation.

[2] The Federal Credit Union Act states that, "In setting and adjusting the total amount of compensation and benefits for employees of the Board, the Board shall seek to maintain comparability with other federal bank regulatory agencies." 12 U.S.C. Section 1766(j)(2).

The NCUA also achieved savings in the employee pay and benefits line item. For example, benefit costs were adjusted downward by $650,000 associated with lower-than-anticipated employee participation in health insurance benefit programs. Also, the agency made assumptions related to staff turnover, which lowered overall pay and benefits because more experienced personnel that separate from NCUA are assumed to be replaced by a combination of entry-level and midcareer staff employees.

Travel:

Travel comprises 11 percent of the overall 2015 budget proposal and reflects less than a three percent increase, or $774,215 over 2014. The total travel budget of $29.3 million includes expenses to cover per diem and lodging, air fare, reimbursements for privately owned vehicle usage, auto rentals, and other travel costs. These are necessary expenses for examiners' on-site work in credit unions. A total of 64 percent of NCUA's workforce is comprised of virtual field staff who spend over 30 percent of their time traveling to conduct the annual examination and supervision program and to a lesser degree to attend training.

The standard government-wide 2015 U.S. General Services Administration lodging and per diem rates are unchanged from 2014; however, there are many non-standard areas with higher per diem rates. This includes large metropolitan cities such as Miami, San Francisco and Boston that reflect an average four percent increase over 2014 lodging and meal expenses. These cost increases, combined with the planned 2015 examination schedule, result in an increase to regional travel. Central office travel expenses will also increase to support field exams. As examples, technical experts such as payment system, capital market, and lending specialists will assist field examiners with program examinations and training, while consumer access analysts will support field consumer compliance issues and follow-up field assessments of business marketing plans for field of membership expansions.

Rent, Communication, and Utilities:

Rent, communication, and utilities proposed at $5.8 million is the smallest component of NCUA's budget and covers mainly the agency's telecommunications and network expenses. Lease and rental expenses as well as utilities and postage are also part of this budget category. Total expenses in this budget category are expected to increase just under three percent, or a net amount of $156,896. Most of this budget line item increase, approximately $200,000, is attributed to telecommunications costs that include the addition of broadband and network connections to improve data capacity and reliability. Additional dedicated communication lines for the central offices and Region I also account for part of this cost increase. Subscription services with financial and portfolio risk analytics critical to support program examinations account for an increase of $47,000.

The agency identified cost savings in this budget category. The leases in Regions II and III were recently renegotiated resulting in savings of approximately $119,000. NCUA continues to support its green initiative by increasing delivering of materials in electronic format and reducing its postal expenditures by $46,000 in 2015. Additionally, an effort to consolidate meeting and training requirements for field staff will result in savings of $64,000.

Administrative Expenses:

Administrative expenses primarily include depreciation and amortization expenses of capital acquisition and software licenses that support operational requirements, FFIEC fees, relocation expenses, and employee supplies. These costs are expected to increase by a net of $941,522 or six percent, for a total budget of $16.3 million for 2015.

Software licensing fees will increase by $137,000 for both new licenses and for inflationary increases on existing licenses. These licenses provide critical analytical tools for examiners to strengthen off-site monitoring, perform asset valuation and risk metrics, enhance statistical surveillance of credit union risks and program efficiencies, and further improve program consistency.

The proposed budget also includes $752,000, an increase of $279,000, to fund NCUA's enterprise agreement for a suite of Microsoft software products. This funding supports server and end-user licensing costs for Microsoft products, including email, word processing, spreadsheet and database management applications. These tools support NCUA's mission achievement across all of the agency's strategic goals. Total software licenses and maintenance fees will cost NCUA $3.1 million in 2015.

In 2015, NCUA's laptops will be at the end of their useful life, in a business setting, which is the prevalent industry standard of three years. Although the annual costs for the computer leases are expected to remain unchanged from 2014, there will be a one-time cost of $365,000 to replace computer peripherals such as docking stations, hard drives, and other accessories.

The agency expects to achieve savings of $90,000 by utilizing webinars and internet resources for small credit union engagements.

Contracted Services:

Contracted services is budgeted at $26.2 million for 2015. The request represents an increase of $2.1 million, or nine percent, over the 2014 budget and is in support of NCUA's top priorities of implementing a robust supervision framework, promoting awareness of critical risks and related threats, developing financial literacy and consumer protection programs, providing guidance to credit unions, and strengthening security programs. The contracted services line items of the budget reflect costs incurred when products and services are acquired in the commercial marketplace through a competitive process for all contracts over $7,500. These services include critical mission support such as information technology hardware and software development support, accounting and auditing services, and specialized subject matter expertise that enable NCUA to meet its mission. Contracting specific expertise is often a cost-effective approach to support career FTEs.

The majority of contract services funding is related to NCUA's priority goal to implement a robust supervision framework, to include identifying and resolving traditional risk concerns such as interest rate risk, credit risk and concentration risk, as well as new and evolving operational risks including cyber-security risks.

A portion of the funding requested for this category is for recurring infrastructure costs to the agency. For example, the agency incurs recurring contracted services funding to maintain a number of NCUA systems including critical legacy systems such as Automated Integrated Regulatory Examination System (AIRES) and CU Online. Other examples include:

- Funding to meet training requirements of the examiner workforce. NCUA's most important resource is a highly qualified, skilled workforce. It is important that staff have the proper knowledge, skills, and abilities to perform assigned duties and meet emerging needs. Examiners are required to attend five levels of examiner training, followed by training in core areas such as capital markets, consumer compliance, and specialized lending. NCUA training program costs, primarily conducted at the agency's training facility in the central office, are expected to remain at the same level as 2014. This includes conducting over 100 training sessions annually with more than 2,100 attendees for both NCUA staff and state supervisory authorities. The central office training facility is in use over 300 calendar days per year. Contract resources will be used to modify and strengthen NCUA examiner training in member business lending. In addition to supporting the agency's programmatic priorities, employee development supports the strategic goal to cultivate an environment that fosters a diverse, well-trained and motivated staff.

- Information technology system costs. These funds for NCUA's information security program are required to strengthen cybersecurity, a high priority to ensure the agency is in compliance with the Federal Information System Management Act .

- Funds for agency financial management services, human resources technology support, and payroll services. NCUA contracts for these services with the U. S. Department of Transportation's Enterprise Service Center and the U.S. General Services Administration.

- Funds to conduct the annual audit for NCUA's five funds.

Funds are also requested to evaluate the staffing structure and analytical software needs to support internally developed stress testing results for natural person credit unions greater than $10 billion in assets. This analysis is expected to cost $100,000. A loan portfolio analysis tool estimated to cost $150,000 will be used to assist with supervision responsibilities for natural person credit unions over $10 billion in assets.

There are several federally mandated security costs such as the secure electronic surveillance system. These costs will increase over the prior year budget by $235,000. Other required security costs are associated with the personally identifiable verification program and background investigation checks and are estimated to increase $110,000. This includes cost increases charged by the Office of Personnel Management for five-year reinvestigations.

Dedicated contractor support was approved during the 2014 mid-session budget review to meet growing audiovisual demands, evolving communication platforms, and enhance staff effectiveness and efficiency through the use of technology. This contractor support will continue to assist NCUA with video teleconferencing, web conferencing, and provide IT support for more efficient training at a cost of $176,000.

There are several minor maintenance projects needed for the King Street Station property to provide general upkeep and replacement items for the 20-year old property in the amount of $140,000. In addition, realtor commission costs to replace an existing tenant expected to move next year is estimated at $85,000.

The U.S. Equal Employment Opportunity Commission has several mandatory compliance requirements. NCUA will hire a contractor to conduct a barrier analysis to assess NCUA's personnel recruitment policies and procedures to ensure there are no employment barriers to full participation in the workplace by individuals of all races and ethnicities. The cost of this contract is estimated to be $185,000. In addition, an expanded workforce recruitment program costing $60,000 will increase hiring opportunities from underrepresented groups. These initiatives support the diversity inclusion requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as NCUA's objective of recruiting and retaining a well-diversified and highly qualified workforce.

Capital Acquisitions:

An itemized listing for $8.9 million of capital acquisitions is provided in Attachment 2.

A total of $5.9 million is requested for information technology software development projects approved by NCUA's Information Technology Prioritization Council. Several of these systems were part of mid-session budget approved projects to plan and assess the specifications to implement these projects.

- $1.5 million: Business Intelligence tools to provide robust enhanced reporting
- $1.3 million: Redesign of the examination management system; Consumer Assistance Center complaint management system replacement
- $1.1 million: CU Online Version 3 for natural person credit unions
- $325,000: Background investigation management system
- $250,000: Enterprise portal for staff to securely share and distribute large files
- $216,000: Replacement of system that supports administrative functions including budget formulation, travel voucher audits, and human resource data.

A total of $200,000 is requested for a new Office of Minority and Women Inclusion data management and complaint tracking system to comply with a recent Office of Inspector General recommendation. A more robust automated system is needed to ensure that the increased level of information required by various government entities is readily available.

A total of $263,000 is requested for information technology hardware including replacement of five-year old regional servers, upgrade of the audiovisual system in the central office, and expansion of production storage infrastructure to meet growing data capacity needs.

A total of $2.5 million is requested for central office building renovation projects. The retail space in the King Street building will be retrofitted to be used as the agency's training facility. Renovation of the vacated space in the central office from the former training rooms will repurpose it for office space. This repurposing project is designed to ensure the central office space will be used more efficiently and will avoid the expense of purchasing or leasing additional space outside of the central office in 2015.

There are also several necessary heating, ventilation, and air conditioning replacement projects as well as electrical upgrades necessary for the ongoing maintenance of the building.

RECOMMENDED ACTIONS: It is recommended that the NCUA Board approve:

1. The fiscal year 2015 budget of $279,747,779 and 1,268.7 FTEs, as presented in Attachment 1.

2. The 2015 capital acquisitions of $8,872,500 as presented in Attachment 2.

ATTACHMENTS: 2015 proposed budget by office, and 2015 capital acquisition schedule.

2015 PROPOSED BUDGET

By Office	2014 Approved Budget	2015 Proposed Budget	Change from 2014 Budget		Full-Time Equivalents			
			$	%	2014		2015	Change
Office of the Board	2,907,078	2,850,042	(57,036)	-2.0%	12.00		12.00	-
Office of the Executive Director	1,685,595	1,793,729	108,134	6.4%	6.00		6.00	-
Office of Continuity and Security Management	1,939,759	2,750,006	810,247	41.8%	7.00	(1)	9.00	2.00
Office of Minority and Women Inclusion	2,500,763	2,904,336	403,573	16.1%	11.00		11.00	-
Office of the Chief Economist	1,466,145	1,608,104	141,959	9.7%	6.00		7.00	1.00
Office of Consumer Protection	9,370,881	9,371,573	692	0.0%	42.00		44.00	2.00
Office of the Chief Financial Officer	20,698,898	20,954,174	255,276	1.2%	39.00		39.00	-
Office of the Chief Information Officer	22,457,281	23,615,383	1,158,102	5.2%	37.00		37.00	-
Office of National Examinations and Supervision	8,938,055	10,095,601	1,157,546	13.0%	36.00		38.00	2.00
Office of Small Credit Union Initiatives	5,981,996	5,925,076	(56,920)	-1.0%	27.00		28.00	1.00
Office of Examination & Insurance	10,458,965	11,374,469	915,504	8.8%	47.50	(2)	48.50	1.00
Office of General Counsel	6,297,796	6,731,200	433,404	6.9%	28.40		28.60	0.20
Office of Inspector General	3,666,524	3,696,971	30,447	0.8%	10.00	(1)	10.00	-
Office of Human Resources	14,759,131	14,615,830	(143,301)	-1.0%	41.00		41.00	-
Office of Public and Congressional Affairs	1,593,601	1,823,235	229,634	14.4%	7.00		7.00	-
Region I - Albany	27,508,828	29,018,875	1,510,047	5.5%	172.00		171.00	(1.00)
Region II - Capital	29,903,077	30,438,021	534,944	1.8%	176.00		175.00	(1.00)
Region III - Atlanta	28,607,889	30,365,620	1,757,731	6.1%	173.00		172.00	(1.00)
Region IV - Austin	30,245,007	31,249,269	1,004,262	3.3%	177.60		176.60	(1.00)
Region V - Tempe	31,095,447	31,882,959	787,512	2.5%	171.00		170.00	(1.00)
Asset Management & Assistance Center	6,207,580	6,413,306	205,726	3.3%	38.00	(3)	38.00	-
Total	**268,290,296**	**279,477,779**	**11,187,483**	**4.2%**	**1,264.5**		**1,268.7**	**4.2**

(1) Includes 1.0 FTE approved at 2014 Mid-Session.
(2) This office contains 7.5 FTE related to other NCUA funds; 3.5 FTE are paid for by the Central Liquidity Facility and 4.0 FTE are paid for by the Temporary Corporate Credit Union Stabilization Fund.
(3) This office contains 1.0 FTE paid for by the Temporary Corporate Credit Union Stabilization Fund.

ATTACHMENT 1

2015 CAPITAL INVESTMENTS/ACQUISITIONS

Description	Estimated Cost
Information technology software development investments approved by ITPC.	$ 6,107,000
Business Intelligence Tools combined with an Enterprise Data Warehouse will expand data storage and strengthen analysis and reporting.	$ 1,500,000
Automated Integrated Regulatory Examination System (AIRES) redesign will improve the primary program exam tool used to manage credit union supervision and examination functions. This system is a critical and primary information source for documenting the indnstry health, safety and soundness.	$ 1,300,000
Consumer Assistance Center New Complaint Management System will modernize and streamline the complaint process to ensure an effective and timely process. The new system will improve customer service and provide accurate information to the public.	$ 1,200,000
CU-online System Upgrade. The central data collection system used by credit unions for quarterly reporting will be updated (version 3) for Natural Person Credit Unions to enhance usability functions and make improve system reliability.	$ 1,116,000
Background Investigation Management System will more effectively manage the sensitive personally identifiable background investigation data, and improve the efficiency of personnel security processing.	$ 325,000
Secure File Transfer solution with an enterprise portal will facilitate the transfer of any file type including loan files, videos, and other large data files.	$ 250,000
Administrative Legacy Systems Replacement will include new systems for budget formulation, travel voucher audits and human resource data management.	$ 216,000
Equal Employment Opportunity Database is required to track and manage complaints and cases to comply with Equal Employment Opportunity Commission regulations .	$ 200,000
Information technology hardware investments	$ 263,000
Audio visual system upgrades to replace outdated equipment and systems.	$ 100,000
Replacement of 5-year old regional servers to ensure compatibility with current technology.	$ 85,000
Production storage capacity upgrades to keep pace with growing data requirements.	$ 78,000
Capital building improvements and repairs	$ 2,502,500
Building renovations for vacated training rooms to repurpose for office and meeting space	$ 1,210,000
Building refurbishments and repairs, such as waterproofing NCUA's Central Office Facility.	$ 740,000
Heating and air conditioning replacements for the NCUA Central Office Facility.	$ 452,500
Building modifications to Region IV (Austin, Texas) to comply with Americans with Disabilities Act	$ 100,000
TOTAL CAPITAL ACQUISITIONS	**$ 8,872,500**

ATTACHMENT 2

OPERATING FUND

PRELIMINARY & UNAUDITED
FINANCIAL HIGHLIGHTS
August 31, 2015

RENDELL L. JONES
CHIEF FINANCIAL OFFICER

NATIONAL CREDIT UNION ADMINISTRATION
OPERATING FUND

MANAGEMENT OVERVIEW
August 31, 2015

Balance Sheet

Cash and cash equivalents had a month-end balance of approximately $65.3 million. Its balance decreased $3.6 million in the month primarily due to monthly realization of deferred revenue, purchase of fixed assets and repayment of National Credit Union Share Insurance Fund long-term note payable. The cash position is considered to be sufficient to cover current and future obligations of the Fund.

Accounts payable had a month-end balance of approximately $2.9 million. Its balance increased by approximately $1.4 million in the month primarily due to a liability created by the estimate-to-actual differences of Operating Fund overhead expenses transfered to the Share Insurance Fund.

Accrued wages and benefits had a month-end balance of approximately $7.1 million. Its balance increased by approximately $718 thousand in the month primarily due to monthly payroll accrual timing differences.

Deferred revenue had a month-end balance of approximately $26.2 million. Its balance decreased by approximately $6.5 million in the month due to the recognition of the monthly operating fee revenue.

Statements of Revenues, Expenses, and Changes in Fund Balance

Net income for the month was $649 thousand and net income year-to-date was $5.0 million. Interest income on overnight investments has averaged 0.03% year-to-date, versus 0.04% during the same period last year.

Statements of Cash Flow

The cash position decreased approximately $3.6 million since last month. In the current month approximately $3.3 million was used for operating expenses. Approximately $158 thousand was invested in new capital assets. Approximately $112 thousand in cash was used to reduce or repay the National Credit Union Share Insurance Fund note payable long-term liability, which has a balance of approximately $10.8 million on the balance sheet.

Budget (Year-to-Date)

Agency spending was under the year-to-date budget by $12.8 million or 7.0%, compared to being under the year-to-date budget by approximately $13.4 million or 7.6% during the same period last year. Of the total variance, employee pay and benefits was under budget by $2.8 million or 2.1%. Travel cost were under budget by $2.2 million or 11.5%. Contract services cost was under budget by $4.2 million or 23.9%. The remaining expense categories combined were under budget by $3.6 million or 24.8%. The under budget amounts are due to the use of straight line budget estimates. Actual costs will more clearly align with budgeted costs as the year progresses.

The average annualized travel spend per Full-Time Equivelant (FTE) was $20,773 this year, which is $309 more than last year.

Vacancies

The Agency had 41 vacancies as of this month—no change from the prior month. Of the 41 vacancies, 9 were in the central office and 32 were in the regions and the Asset Management and Assistance Center (AMAC). The 41 vacancies represent 3.2% percent of total authorized staff of 1,268.70.

NATIONAL CREDIT UNION ADMINISTRATION
OPERATING FUND
BALANCE SHEETS
As of August 31, 2015
(Dollars in thousands)

	August 2015	August 2014
ASSETS		
CASH AND CASH EQUIVALENTS	$ 65,310	$ 62,723
DUE FROM NATIONAL CREDIT UNION SHARE INSURANCE FUND	-	68
EMPLOYEE ADVANCES	29	128
OTHER ACCOUNTS RECEIVABLE , Net	563	216
PREPAID EXPENSES AND OTHER ASSETS	2,457	1,888
ASSETS HELD FOR SALE	207	244
FIXED ASSETS — Net of accumulated depreciation of $30,465	31,962	29,629
INTANGIBLE ASSETS — Net of accumulated amortization of $16,890 as of August 31, 2015	2,303	3,083
TOTAL ASSETS	$ 102,831	$ 97,979
LIABILITIES		
Accounts payable	$ 2,887	$ 4,657
Obligations under capital leases	1,894	59
Accrued wages and benefits	7,081	5,749
Deferred revenue (1)	26,219	25,958
Accrued annual leave	15,469	14,571
Note payable to National Credit Union Share Insurance Fund	10,839	12,180
TOTAL LIABILITIES	64,389	63,174
FUND BALANCE	38,442	34,805
TOTAL LIABILITIES AND FUND BALANCE	$ 102,831	$ 97,979

(1) The Operating Fund recognizes operating fee revenue ratably over the calendar year. The deferred revenue is the remaining amount to be recognized over the remainder of the calendar year.

The balances in the statement above are preliminary and unaudited

NATIONAL CREDIT UNION ADMINISTRATION
OPERATING FUND
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND BALANCE
For the Periods Ended August 31, 2015 and August 31, 2014
(Dollars in thousands)

	August 2015	Year-to-Date August 2015	Year-to-Date August 2014
REVENUES			
Operating fees	$ 6,498	$ 52,565	$ 51,917
Interest	3	9	12
Other	76	753	863
Total Revenues	6,577	53,327	52,792
EXPENSES, NET (1)			
Employee wages and benefits, net	4,379	36,677	37,665
Travel	675	4,799	5,150
Rent, communications, and utilities	100	750	945
Contracted services	517	3,754	3,908
Depreciation and amortization	480	3,775	3,950
Administrative	(223)	(1,442)	(1,154)
Total Expenses	5,928	48,313	50,464
EXCESS OF REVENUES OVER / (UNDER) EXPENSES	649	5,014	2,328
FUND BALANCE—Beginning of period	37,793	33,428	32,477
FUND BALANCE—End of period	$ 38,442	$ 38,442	$ 34,805

(1) Operating Fund expenses are the total NCUA operating expenses minus the Share Insurance Fund allocation as determined by the overhead transfer rate set by the board of 71.8% and 69.2% for 2015 and 2014, respectively.

The balances in the statement above are preliminary and unaudited

NATIONAL CREDIT UNION ADMINISTRATION
OPERATING FUND
STATEMENTS OF CASH FLOWS
For the Periods Ended August 31, 2015 and August 31, 2014
(Dollars in thousands)

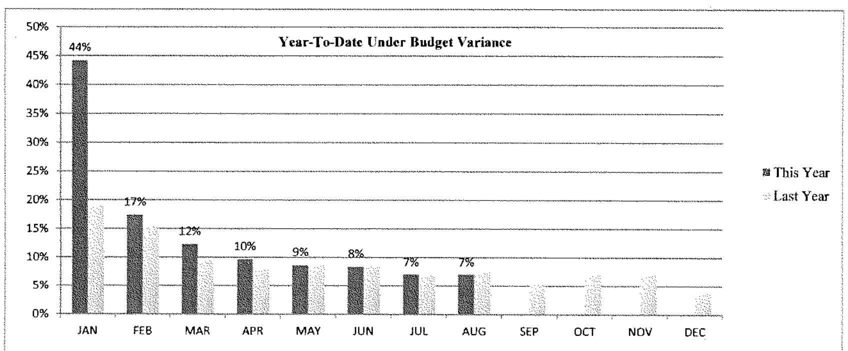
	August 2015	Year-to-Date August 2015	Year-to-Date August 2014
CASH FLOWS FROM OPERATING ACTIVITIES:			
Excess of revenues over expenses	$ 649	$ 5,014	$ 2,328
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:			
Depreciation and amortization	480	3,775	3,950
Provision for loss on disposal of employee residences held for sale	-	47	-
(Gain) loss on fixed asset retirements	1	12	-
(Increase) decrease in assets:			
Due from National Credit Union Share Insurance Fund	82	3,509	3,245
Employee advances	26	33	(90)
Other accounts receivable	(116)	(241)	(13)
Prepaid expenses and other assets	-	(312)	(510)
(Decrease) increase in liabilities:			
Accounts payable	1,387	(3,711)	(61)
Accrued wages and benefits	718	(5,792)	(5,607)
Deferred revenue	(6,544)	26,219	25,958
Accrued employee travel	-	(491)	(1,068)
Net cash (used) or provided by operating activities	(3,317)	28,062	28,132
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of fixed and intangible assets	(158)	(2,837)	(2,184)
Proceeds from insurance on fixed assets	-	-	-
Purchases of employee residences held for sale	-	(207)	(244)
Proceeds from sale of employee residences held for sale	-	596	-
Net cash used by investing activities	(158)	(2,448)	(2,428)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Repayments of note payable to National Credit Union Share Insurance Fund	(112)	(894)	(894)
Principal payments under capital lease obligations	-	(350)	-
Net cash used by financing activities	(112)	(1,244)	(894)
NET (DECREASE) OR INCREASE IN CASH AND CASH EQUIVALENTS	(3,587)	24,370	24,810
CASH AND CASH EQUIVALENTS—Beginning of period	68,897	40,940	37,913
CASH AND CASH EQUIVALENTS—End of period	$ 65,310	$ 65,310	$ 62,723
SUPPLEMENTAL DISCLOSURE OF NONCASH ACTIVITIES			
Acquisition of equipment under capital lease	$ -	$ 2,030	$ -
Cash Payments for Interest	$ 17	$ 140	$ 154

The balances in the statement above are preliminary and unaudited

NATIONAL CREDIT UNION ADMINISTRATION
OPERATING FUND

YEAR-TO-DATE BUDGET REPORT ANALYSIS (BEFORE OVERHEAD TRANSFER RATE)
As of August 31, 2015 and August 31, 2014
(Dollars in thousands)

	Year-To-Date 2015				Year-To-Date 2014			
	BUDGET [1]	ACTUAL	DIFF	%	BUDGET [1]	ACTUAL	DIFF	%
Employee Pay & Benefits	132,881	130,062	(2,819)	-2.1%	127,919	122,288	(5,631)	-4.4%
Travel	19,223	17,016	(2,207)	-11.5%	19,014	16,722	(2,292)	-12.1%
Rent, Comm., & Utilities	3,616	2,658	(958)	-26.5%	3,782	3,067	(715)	-18.9%
Administrative	10,920	8,275	(2,644)	-24.2%	10,341	9,079	(1,262)	-12.2%
Contracted Services	17,482	13,306	(4,176)	-23.9%	16,151	12,672	(3,480)	-21.5%
TOTAL	184,121	171,317	(12,804)	-7.0%	177,207	163,827	(13,380)	-7.6%

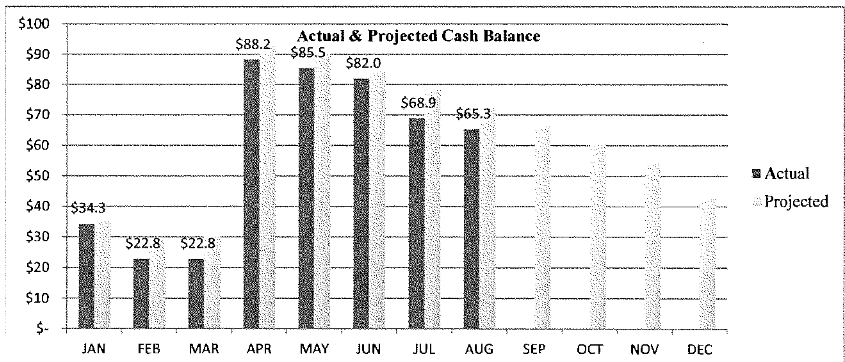


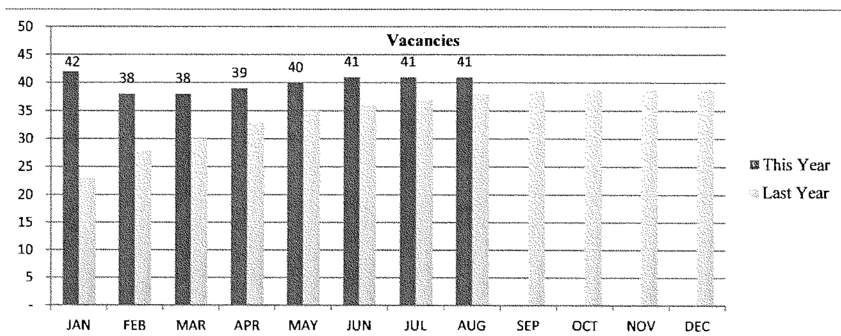
[1]Budget amounts reflect the Board-approved base budget plus mid-session adjustments.

The balances in the supplement above are preliminary and unaudited

NATIONAL CREDIT UNION ADMINISTRATION
OPERATING FUND

GRAPHS AND RATIOS
As of August 31, 2015 and August 31, 2014





	8/31/2015	8/31/2014
Fund Balance / Total assets	37.38%	35.52%
YTD interest income to average investments (annualized)	0.03%	0.04%
Annualized travel spend per employee	$20,773	$20,464
Net year to date cash inflow (outflow) in millions of dollars	$24	$25
Cash and overnight investments / Total assets	63.51%	64.02%
Overhead transfer rate	71.80%	69.20%

The balances in the supplement above are preliminary and unaudited

2015 BUDGET – CONTRACT SERVICES

Operating Fund

- The 2015 NCUA operating fund budget of $279.5 million includes $26.2 million for contracted services, which is 9 percent of the total operating fund budget.

- This budget supports NCUA's top priorities to implement a robust supervision framework, promote awareness of critical risks and related threats, develop financial literacy and consumer protection programs that provide guidance to credit unions, and strengthen security programs.

- The contracted services budget represents costs incurred for products and services acquired in the federal government and commercial marketplace through a competitive process for all contracts over $7,500. These services include such services as federal shared service provider for accounting and payroll systems and services, information technology hardware and software development support, accounting and auditing services and specialized subject-matter expertise that enables NCUA to meet its mission.

- The majority of our contracted services are related to NCUA's priority goal of implementing a robust supervision framework, and identifying and resolving traditional risk concerns such as interest rate risk, credit risk and concentration risk, as well as new and evolving operational risks like cyber-security risks. Other major contract spending includes:

  - **Information Technology Infrastructure Costs.** There are recurring maintenance expenses to support critical internal systems such as the Automated Integrated Regulatory Examination System (AIRES) and CU Online that support the credit union examination program. This includes development costs to replace legacy IT systems that have exceeded their expected useful life and new applications to improve the efficiency and effectiveness of the agency.

    Information technology system costs for NCUA's information security program are required to strengthen cybersecurity, a high priority to ensure the agency complies with the Federal Information System Management Act.

  - **Training Requirements of the Highly Qualified and Skilled Examiner Workforce.** It is important that staff have the proper knowledge, skills and abilities to perform assigned duties and meet emerging needs. Newly hired examiners are required to attend a predefined curriculum that includes training in capital markets, consumer compliance and specialized lending. All staff complete an annual Individual Development Plan outlining up to 80 classroom hours to maintain and improve their skills and expertise. Employee development supports the agency's strategic goal to cultivate an environment that fosters a diverse, well-trained and motivated staff.

- **Financial Management Services, Human Resources and Payroll Services.** NCUA contracts for these services with the U. S. Department of Transportation's Enterprise Service Center and the U.S. General Services Administration.

- **Outside Audits.** NCUA contracts with outside parties to conduct the annual audits for NCUA's five funds.

- **Mandatory Compliance Requirements for the U.S. Equal Employment Opportunity Commission.** NCUA hires contractors to conduct a barrier analysis to assess NCUA's personnel recruitment policies and procedures to ensure there are no barriers to full participation in the agency's workplace by individuals of all races and ethnicities. These initiatives support the diversity inclusion requirements outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as NCUA's objectives for diversity.

Stabilization Fund

- Contract costs represent 73 percent of the Corporate Stabilization Fund's budget of $4.1 million. The $3 million of contract services is needed to meet our fiduciary requirements and includes such things as hiring outside professional services such as external valuation experts, tax consultants, financial specialists and accountants. The majority of personnel needed to operate the Corporate Stabilization Fund are managed through contractors because the fund is temporary.

  - Valuation services support efforts to maximize the value of the asset management estates and determine the current value of legacy assets. Without these services, NCUA would be unable to assess macroeconomic changes that could materially affect the value of the legacy assets.

  - Accounting and audit services support two central offices in NCUA: the offices of Examination and Insurance and the Chief Financial Officer. They include a quarterly due diligence process on contract valuations as well as analyses on emerging issues. Support for the annual financial audit process and emerging issues is also provided by contractors and include tasks that support complex accounting and financial requirements for settlements, sale of legacy assets, parity payments, changing valuation model assumptions, and disposition planning such as re-securitization. Other accounting services include performing internal control assessments and providing accounting services in support of the annual financial statement audit.

  - Software and data subscription services support standard tools that provide models, calculations, and metrics for the structured investment products underlying the NCUA guaranteed notes (NGN) portfolio. Financial analytics data play a critical role in the surveillance, modeling, and pricing of the legacy assets that comprise the NGN Trusts, as well as supporting the due diligence NCUA performs on the cash flow projections provided by its contract support.

Central Liquidity Fund

- The CLF is a mixed-ownership government corporation managed by the NCUA Board and owned by its member credit unions. There are some financial service support fees and professional training and development included in the annual CLF operating expenses.

Share Insurance Fund

- The Federal Credit Union Act permits the Share Insurance fund to cover administrative and other necessary expenses. Financial operations and audit support are ongoing requirements to support the production of audited financial statements that receive clean opinions. Because the financial audit support work is cyclical, contractor staff is best suited to perform this work.

Operating Fund Contracted Services by Office*

Office of the Board	
Description	2015 Budget
Professional training and development	12,000
Temporary labor	1,500
Communication and media support services	123,000
Total Contracted Services	**$ 136,500**

Office of the Executive Director	
Description	2015 Budget
Executive conference and meeting services	200,000
Professional training and development	75,000
Strategic planning conference support	35,000
Total Contracted Services	**$ 310,000**

Office of Continuity and Security Management	
Description	2015 Budget
Guard and security services	719,480
Cyber security services	50,000
Professional training and development	41,000
Employee background investigations	394,212
Total Contracted Services	**$ 1,204,692**

*Total operating expenses before 71.8 percent of expenses are transferred to Share Insurance Fund in accordance with the November 14, 2014, Board Action Memoranda on the operating fee and overhead transfer rate. The Office of Inspector General contract detail is not included.

NCUA

Operating Fund Contracted Services by Office

Office of Minority and Women Inclusion	
Description	2015 Budget
Mediations/counseling/investigations	130,500
Supplier diversity program review	9,500
Diversity training	15,400
Professional training and development	27,794
Intern/student programs	312,000
Diversity Program Events	29,000
Equal employment opportunity (EEO) training	7,200
EEO barrier analysis	200,000
EEO programs	89,000
Total Contracted Services	**$ 820,394**

Office of the Chief Economist	
Description	2015 Budget
Professional training and development	4,500
Total Contracted Services	**$ 4,500**

Office of Consumer Protection	
Description	2015 Budget
Regulatory consumer compliance implementation support	250,050
Professional training and development	62,502
Consumer protection and compliance training	45,000
Youth financial literacy study	25,000
Total Contracted Services	**$ 382,552**

Operating Fund Contracted Services by Office

Office of National Examination and Supervision	
Description	2015 Budget
Professional training and development	69,600
Investment monitoring system	137,796
Online business and financial research service	44,165
Risk assessment services	157,000
Resource planning assessment	100,000
Portfolio analytical services and tools	168,000
Total Contracted Services	**$ 676,561**

Office of the Chief Financial Officer	
Description	2015 Budget
Maintenance, repair and other building services (net with tenant reimbursement)	982,711
Printer and shredder maintenance	18,500
Accounting system support	1,918,145
Audit support	828,200
Payroll/HR systems support	232,500
Travel processing fees	20,000
Professional training and development	87,000
Agency-wide new laptop training	130,000
Accounting report services	75,000
Printing services	372,445
Facility, graphics and mailing services	102,000
Total Contracted Services	**$ 4,766,501**

Operating Fund Contracted Services by Office

Office of the Chief Information Officer	
Description	2015 Budget
Network, server and printer maintenance	220,000
Records management/storage	47,600
Administrative support services	96,820
Security management	150,000
Information technology support services	1,230,560
Network consulting support services	1,076,528
Information security and audit support	1,100,000
Professional training and development	133,000
System programming support	4,328,854
Credit Union On-line maintenance	1,000,000
System development support	637,120
Audio visual support	191,590
Administrative systems maintenance	96,000
Total Contracted Services	**$ 10,308,072**

Office of Small Credit Union Initiatives	
Description	2015 Budget
Training facilitators and instructors	21,000
Professional training and development	47,000
Low income credit union training	37,500
Total Contracted Services	**$ 105,500**

NCUA

Operating Fund Contracted Services by Office

Office of Examination and Insurance	
Description	2015 Budget
Professional training and development	106,500
Credit union program examination systems	625,000
Management and organizational support	425,000
Member business lending and cyber security training	175,000
Total Contracted Services	**$ 1,331,500**

Office of General Counsel	
Description	2015 Budget
Administrative legal fees (admin law judge, court reporter, etc)	175,000
Professional training and development	16,000
Legal support	34,000
Total Contracted Services	**$ 225,000**

Office of Human Resources	
Description	2015 Budget
Investigative support services	25,000
Financial, management, and examiner training	1,183,807
Examiner Certification Testing	385,000
Conference planning and support	250,000
NCUA Savings Plan administrative costs	254,000
OHR administrative and labor relations support	117,500
HR system operation and maintenance and support	295,000
Professional training and development, executive conference and meetings	336,200
Employee assistance programs	141,838
Conference security support	12,000
Total Contracted Services	**$ 3,000,345**

Operating Fund Contracted Services by Office

Office of Public and Congressional Affairs	
Description	2015 Budget
Training facilitators and instructors	12,000
Professional training and development	21,000
Administrative support services	114,000
Communication and media support services	323,700
Total Contracted Services	**$ 470,700**

Region 1	
Description	2015 Budget
Copier/printer lease and maintenance	7,215
Program exam and audit support	22,750
Professional training and development	70,903
Building and office services	17,700
Total Contracted Services	**$ 118,568**

Region 2	
Description	2015 Budget
Copier/printer lease and maintenance	2,000
Program exam and audit support	75,000
Professional training and development	111,452
Building and office services	5,162
Training facilitators and instructors	1,000
Total Contracted Services	**$ 194,614**

Operating Fund Contracted Services by Office

Region 3		
Description		2015 Budget
Office building repairs		1,000
Copier/printer lease and maintenance		10,448
Program exam and audit support		94,500
Professional training and development		85,400
Total Contracted Services	**$**	**191,348**

Region 4		
Description		2015 Budget
Copier/printer lease and maintenance		7,121
Professional training and development		115,099
Building and office services		1,300
Interpreter services		19,360
Professional development team training		21,317
Total Contracted Services	**$**	**164,197**

Region 5		
Description		2015 Budget
Building repairs		3,500
Copier/printer lease and maintenance		15,000
Professional training and development		81,000
Building and office services		1,400
Training facilitators and instructors		10,000
Media service		800
Total Contracted Services	**$**	**111,700**

Operating Fund Contracted Services by Office

Asset Management and Assistance Center	
Description	2015 Budget
Building repairs	2,500
Copier/printer lease and maintenance	15,000
Financial service maintenance	80,000
Legal	1,000
Professional training and development	55,000
Total Contracted Services	**$ 153,500**

Other NCUA Fund Contracted Services

Stabilization Fund

Valuation Services		1,250,000
Accounting and Audit Support		992,000
Software/Data Subscription		757,000
Total	**$**	**2,999,000**

Central Liquidity Fund

Agent and bank service fees		68,300
Training		4,000
Total	**$**	**72,300**

Share Insurance Fund*

Financial Statement Audit Support		520,000
Training for State Supervisory Personnel		606,032
Treasury service fees		35,048
Total	**$**	**1,161,080** *

*Includes total budgeted direct charges. In addition, 71.8 percent of the Operating Fund's actual expenses will be transferred to the Share Insurance Fund in accordance with the November 14, 2014 Board Action Memoranda on the operating fee and overhead transfer rate.

NCUA 2015 BUDGET DETAIL

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	146,404,733
	11150 PART-TIME SALARY	669,234
	11200 OVERTIME	149,400
	11500 TERM LEAVE	1,200,000
	11600 ACCRUED ANNUAL LEAVE	1,000,000
	11910 VACANCY DIFFERENTIAL	-3,775,000
	11950 OUT OF USA DIFF	136,104
		145,784,471
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	789,705
	12142 HEALTH BENEFITS	11,546,587
	12143 LIFE INSURANCE	342,968
	12144 OASDI/MEDICARE	9,599,132
	12145 VISION AND DENTAL	1,007,932
	12147 FERS RETIREMENT	17,924,606
	12148 TSP	6,400,107
	12149 401K CONT	6,177,587
	12511 CASH AWARDS	767,800
	12512 ON THE SPOT AWDS	200,500
	12513 AWARD CEREMONY	15,000
	12610 NEW HIRE RELOCATION	15,000
	12620 TRAVEL BONUS	1,089,185
	12631 WKRS COMP	225,000
	12632 UNEMP COMP	35,000
	12950 HEALTH MAINT	91,525
	12970 TRANSP SUBSIDY	93,000
	12980 OTHER PERS SVCS	28,020
	12982 REIMB NCUA STAFF	-238,028
		56,110,625
TRAVEL EXPENSES	22000 POV	4,778,452
	24000 PER DIEM/LODGING	16,738,640
	26000 AIR FARES	5,429,070
	28000 AUTO RENTALS	962,231
	29000 OTHER TRAVEL COSTS	1,380,401
		29,288,793
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	98,255
	31500 TELEPHONE	2,586,467
	32100 SPACE RENTAL	1,671,777
	33000 MISC RENTALS	931,981
	34100 POSTAGE	153,907
	39000 UTILITIES	329,700
		5,772,087
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	235,465
	42000 PRINTING	420,275
	43000 SUPPLIES/MATERIALS	4,152,270
	43200 SUBS/PUBS	557,405
	43210 SUBS/PUBS STIPEND	10,000
	43700 REFRESHMENTS/OUTREACH	613,673
	45110 DEPR - FURN & EQUIP	4,000,000
	45120 DEPR - BUILDING	1,661,571
	48100 MISC REL EXPENSES	1,000,000
	49220 REP EXPENSES	18,900
	49300 INTEREST EXPENSE	227,000
	49400 RECRUITMENT/ADV	406,252
	49610 CREDIT REPORTS	3,535
	49840 FFIEC	519,376
	49841 HMDA	798,591
	49900 SETTLEMENTS	150,000
	49999 MISC ADMIN OTHER	1,560,445
		16,334,758
CONTRACTED SERVICES	52110 SPACE REPAIRS/ALT	7,000
	52200 KSS MAINTENANCE	2,127,431
	52290 EQUIP REPAIR/MAINT	375,284
	55100 COMPUTER EXP	47,600
	55700 INV/GRIEVANCES	155,500
	55900 CONSULTING	7,187,415
	56900 LEGAL FEES	176,500
	58000 ACCTG/PAYROLL/HR	4,188,845
	59220 SPECIAL TRAINING	155,000
	59230 M/S TRAINING	459,383
	59240 NON-SUPER TRAINING	1,022,367
	59250 SSP TRAINING	73,000
	59600 TEMPORARY LABOR	350,500
	59800 PARKING EXPENSE	-165,240
	59820 KSS-RENTAL REIMB	-260,000
	59999 MISC CONT SVCS	10,286,459
		26,187,044
		279,477,779

The Office of The Inspector General budget detail is not included.

2015 Office of the Board Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	1,880,745
		1,880,745
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	44,313
	12142 HEALTH BENEFITS	109,291
	12143 LIFE INSURANCE	3,521
	12144 OASDI/MEDICARE	92,494
	12145 VISION AND DENTAL	9,504
	12147 FERS RETIREMENT	164,696
	12148 TSP	62,061
	12149 401K CONT	78,991
	12511 CASH AWARDS	8,500
		573,372
TRAVEL EXPENSES	22000 POV	7,650
	24000 PER DIEM/LODGING	77,750
	26000 AIR FARES	78,000
	28000 AUTO RENTALS	9,500
	29000 OTHER TRAVEL COSTS	21,700
		194,600
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	1,200
	33000 MISC RENTALS	1,200
	34100 POSTAGE	150
		2,550
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	15,000
	43700 REFRESHMENTS/OUTREACH	34,275
	49220 REP EXPENSES	13,000
		62,275
CONTRACTED SERVICES	59230 M/S TRAINING	2,500
	59240 NON-SUPER TRAINING	9,500
	59600 TEMPORARY LABOR	1,500
	59999 MISC CONT SVCS	123,000
		136,500
		2,850,042

2015 Office of the Executive Director Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	1,076,832
		1,076,832
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	48,494
	12142 HEALTH BENEFITS	46,916
	12143 LIFE INSURANCE	1,510
	12144 OASDI/MEDICARE	33,101
	12145 VISION AND DENTAL	4,752
	12147 FERS RETIREMENT	50,695
	12148 TSP	19,203
	12149 401K CONT	45,227
	12511 CASH AWARDS	32,000
	12610 NEW HIRE RELOCATION	15,000
		296,898
TRAVEL EXPENSES	22000 POV	2,000
	24000 PER DIEM/LODGING	16,500
	26000 AIR FARES	16,500
	28000 AUTO RENTALS	2,000
	29000 OTHER TRAVEL COSTS	3,000
		40,000
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	500
	33000 MISC RENTALS	19,500
		20,000
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	2,500
	43200 SUBS/PUBS	3,000
	43700 REFRESHMENTS/OUTREACH	42,000
	49220 REP EXPENSES	1,000
	49999 MISC ADMIN OTHER	1,500
		50,000
CONTRACTED SERVICES	55900 CONSULTING	200,000
	59240 NON-SUPER TRAINING	2,000
	59250 SSP TRAINING	73,000
	59999 MISC CONT SVCS	35,000
		310,000
		1,793,729

2015 Office of Continuity and Security Management Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	1,098,141
		1,098,141
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	12,935
	12142 HEALTH BENEFITS	60,190
	12143 LIFE INSURANCE	2,727
	12144 OASDI/MEDICARE	72,685
	12145 VISION AND DENTAL	7,128
	12147 FERS RETIREMENT	120,562
	12148 TSP	45,186
	12149 401K CONT	46,122
	12511 CASH AWARDS	4,000
		371,535
TRAVEL EXPENSES	22000 POV	4,754
	24000 PER DIEM/LODGING	9,384
	26000 AIR FARES	15,000
	28000 AUTO RENTALS	6,000
	29000 OTHER TRAVEL COSTS	7,500
		42,638
RENT/COM/UTILITIES	33000 MISC RENTALS	1,200
		1,200
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	30,000
	43200 SUBS/PUBS	1,500
	43700 REFRESHMENTS/OUTREACH	300
		31,800
CONTRACTED SERVICES	52200 KSS MAINTENANCE	719,480
	55900 CONSULTING	50,000
	59220 SPECIAL TRAINING	25,000
	59230 M/S TRAINING	7,000
	59240 NON-SUPER TRAINING	9,000
	59999 MISC CONT SVCS	394,212
		1,204,692
		2,750,006

2015 Office of Minority and Women Inclusion Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	1,430,647
		1,430,647
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	18,432
	12142 HEALTH BENEFITS	117,235
	12143 LIFE INSURANCE	4,006
	12144 OASDI/MEDICARE	79,974
	12145 VISION AND DENTAL	8,712
	12147 FERS RETIREMENT	154,088
	12148 TSP	55,383
	12149 401K CONT	60,087
	12511 CASH AWARDS	5,000
		502,917
TRAVEL EXPENSES	22000 POV	2,871
	24000 PER DIEM/LODGING	29,600
	26000 AIR FARES	21,150
	28000 AUTO RENTALS	80
	29000 OTHER TRAVEL COSTS	5,929
		59,630
RENT/COM/UTILITIES	33000 MISC RENTALS	2,500
		2,500
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	4,600
	43000 SUPPLIES/MATERIALS	1,800
	43200 SUBS/PUBS	5,283
	43700 REFRESHMENTS/OUTREACH	2,325
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	54,545
	49999 MISC ADMIN OTHER	19,395
		88,248
CONTRACTED SERVICES	55700 INV/GRIEVANCES	130,500
	55900 CONSULTING	24,900
	59230 M/S TRAINING	2,000
	59240 NON-SUPER TRAINING	25,794
	59600 TEMPORARY LABOR	312,000
	59999 MISC CONT SVCS	325,200
		820,394
		2,904,336

2015 Office of the Chief Economist Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	991,516
		991,516
EMPLOYEE BENEFITS	12142 HEALTH BENEFITS	56,448
	12143 LIFE INSURANCE	2,200
	12144 OASDI/MEDICARE	62,373
	12145 VISION AND DENTAL	5,544
	12147 FERS RETIREMENT	130,880
	12148 TSP	48,183
	12149 401K CONT	41,644
	12511 CASH AWARDS	3,000
		350,271
TRAVEL EXPENSES	22000 POV	4,104
	24000 PER DIEM/LODGING	14,470
	26000 AIR FARES	9,771
	28000 AUTO RENTALS	175
	29000 OTHER TRAVEL COSTS	2,980
		31,500
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	500
		500
ADMINISTRATIVE	43200 SUBS/PUBS	224,817
	43700 REFRESHMENTS/OUTREACH	5,000
		229,817
CONTRACTED SERVICES	59240 NON-SUPER TRAINING	4,500
		4,500
		1,608,104

2015 Office of Consumer Protection Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	5,352,530
	11200 OVERTIME	10,000
		5,362,530
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	33,500
	12142 HEALTH BENEFITS	392,568
	12143 LIFE INSURANCE	12,874
	12144 OASDI/MEDICARE	365,777
	12145 VISION AND DENTAL	34,848
	12147 FERS RETIREMENT	643,362
	12148 TSP	222,465
	12149 401K CONT	224,806
	12511 CASH AWARDS	21,000
	12620 TRAVEL BONUS	5,000
		1,956,201
TRAVEL EXPENSES	22000 POV	26,781
	24000 PER DIEM/LODGING	516,383
	26000 AIR FARES	179,697
	28000 AUTO RENTALS	22,914
	29000 OTHER TRAVEL COSTS	45,285
		791,060
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	7,355
	33000 MISC RENTALS	21,575
	34100 POSTAGE	500
		29,430
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	23,500
	43200 SUBS/PUBS	26,109
	49400 RECRUITMENT/ADV	1,000
	49610 CREDIT REPORTS	600
	49841 HMDA	798,591
		849,800
CONTRACTED SERVICES	55900 CONSULTING	250,050
	59230 M/S TRAINING	15,000
	59240 NON-SUPER TRAINING	47,502
	59999 MISC CONT SVCS	70,000
		382,552
		9,371,573

2015 Office of National Examinations and Supervision Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	5,570,292
		5,570,292
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	11,487
	12142 HEALTH BENEFITS	353,248
	12143 LIFE INSURANCE	13,434
	12144 OASDI/MEDICARE	347,510
	12145 VISION AND DENTAL	30,096
	12147 FERS RETIREMENT	713,617
	12148 TSP	249,389
	12149 401K CONT	233,952
	12511 CASH AWARDS	18,000
	12620 TRAVEL BONUS	101,525
		2,072,259
TRAVEL EXPENSES	22000 POV	47,460
	24000 PER DIEM/LODGING	982,631
	26000 AIR FARES	517,120
	28000 AUTO RENTALS	68,706
	29000 OTHER TRAVEL COSTS	97,725
		1,713,642
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	4,500
	33000 MISC RENTALS	16,653
	34100 POSTAGE	380
		21,533
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	15,050
	43200 SUBS/PUBS	1,422
	43700 REFRESHMENTS/OUTREACH	14,542
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	10,000
		41,314
CONTRACTED SERVICES	59230 M/S TRAINING	14,600
	59240 NON-SUPER TRAINING	55,000
	59999 MISC CONT SVCS	606,961
		676,561
		10,095,601

2015 Office of the Chief Financial Officer Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	4,757,738
	11200 OVERTIME	11,000
	11500 TERM LEAVE	1,200,000
	11600 ACCRUED ANNUAL LEAVE	1,000,000
	11910 VACANCY DIFFERENTIAL	-2,600,000
		4,368,738
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	64,333
	12142 HEALTH BENEFITS	291,036
	12143 LIFE INSURANCE	10,968
	12144 OASDI/MEDICARE	278,121
	12145 VISION AND DENTAL	30,888
	12147 FERS RETIREMENT	506,707
	12148 TSP	179,879
	12149 401K CONT	199,825
	12511 CASH AWARDS	143,500
	12970 TRANSP SUBSIDY	93,000
	12982 REIMB NCUA STAFF	-238,028
		1,560,231
TRAVEL EXPENSES	22000 POV	3,300
	24000 PER DIEM/LODGING	52,000
	26000 AIR FARES	34,000
	28000 AUTO RENTALS	3,500
	29000 OTHER TRAVEL COSTS	5,000
		97,800
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	1,500
	31500 TELEPHONE	3,200
	32100 SPACE RENTAL	80,819
	33000 MISC RENTALS	30,000
	34100 POSTAGE	140,000
	39000 UTILITIES	329,700
		585,219
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	175,100
	42000 PRINTING	412,000
	43000 SUPPLIES/MATERIALS	350,500
	43200 SUBS/PUBS	86,515
	43210 SUBS/PUBS STIPEND	10,000
	43700 REFRESHMENTS/OUTREACH	73,000
	45110 DEPR - FURN & EQUIP	4,000,000
	45120 DEPR - BUILDING	1,661,571
	48100 MISC REL EXPENSES	1,000,000
	49300 INTEREST EXPENSE	227,000
	49900 SETTLEMENTS	150,000
	49999 MISC ADMIN OTHER	1,430,000
		9,575,686
CONTRACTED SERVICES	52200 KSS MAINTENANCE	1,407,951
	52290 EQUIP REPAIR/MAINT	18,500
	58000 ACCTG/PAYROLL/HR	2,998,845
	59230 M/S TRAINING	15,500
	59220 SPECIAL TRAINING	130,000
	59240 NON-SUPER TRAINING	71,500
	59600 TEMPORARY LABOR	12,000
	59800 PARKING EXPENSE	-165,240
	59820 KSS-RENTAL REIMB	-260,000
	59999 MISC CONT SVCS	537,445
		4,766,501
		20,954,174

2015 Office of The Chief Information Officer Budget

Groupings	Cost Element		Annual Budget
EMPLOYEE PAY	11110	REGULAR SALARY	5,330,549
	11200	OVERTIME	20,600
			5,351,149
EMPLOYEE BENEFITS	12142	HEALTH BENEFITS	329,596
	12143	LIFE INSURANCE	13,205
	12144	OASDI/MEDICARE	337,592
	12145	VISION AND DENTAL	29,304
	12147	FERS RETIREMENT	703,632
	12148	TSP	263,742
	12149	401K CONT	223,883
	12511	CASH AWARDS	17,500
			1,918,454
TRAVEL EXPENSES	22000	POV	7,400
	24000	PER DIEM/LODGING	74,000
	26000	AIR FARES	54,400
	28000	AUTO RENTALS	5,225
	29000	OTHER TRAVEL COSTS	12,400
			153,425
RENT/COM/UTILITIES	31500	TELEPHONE	2,421,592
	33000	MISC RENTALS	354,000
			2,775,592
ADMINISTRATIVE	43000	SUPPLIES/MATERIALS	3,064,691
	43200	SUBS/PUBS	44,000
			3,108,691
CONTRACTED SERVICES	52290	EQUIP REPAIR/MAINT	220,000
	55100	COMPUTER EXP	47,600
	55900	CONSULTING	3,653,908
	59230	M/S TRAINING	18,000
	59240	NON-SUPER TRAINING	115,000
	59999	MISC CONT SVCS	6,253,564
			10,308,072
			23,615,383

2015 Office of Small Credit Union Initiative Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	3,892,183
	11200 OVERTIME	1,000
		3,893,183
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	31,642
	12142 HEALTH BENEFITS	245,333
	12143 LIFE INSURANCE	9,663
	12144 OASDI/MEDICARE	231,260
	12145 VISION AND DENTAL	22,176
	12147 FERS RETIREMENT	454,101
	12148 TSP	159,332
	12149 401K CONT	163,472
	12511 CASH AWARDS	13,000
	12620 TRAVEL BONUS	12,000
		1,341,979
TRAVEL EXPENSES	22000 POV	48,814
	24000 PER DIEM/LODGING	227,650
	26000 AIR FARES	137,250
	28000 AUTO RENTALS	11,400
	29000 OTHER TRAVEL COSTS	49,250
		474,364
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	10,200
	32100 SPACE RENTAL	100
	33000 MISC RENTALS	24,500
	34100 POSTAGE	200
		35,000
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	4,400
	42000 PRINTING	3,250
	43000 SUPPLIES/MATERIALS	23,000
	43200 SUBS/PUBS	7,400
	43700 REFRESHMENTS/OUTREACH	34,000
	49400 RECRUITMENT/ADV	3,000
		75,050
CONTRACTED SERVICES	55900 CONSULTING	21,000
	59230 M/S TRAINING	10,000
	59240 NON-SUPER TRAINING	37,000
	59999 MISC CONT SVCS	37,500
		105,500
		5,925,076

2015 Office of Examination and Insurance Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	7,266,803
	11150 PART-TIME SALARY	129,443
	11910 VACANCY DIFFERENTIAL	-975,000
		6,421,245
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	83,026
	12142 HEALTH BENEFITS	478,847
	12143 LIFE INSURANCE	17,595
	12144 OASDI/MEDICARE	409,899
	12145 VISION AND DENTAL	38,808
	12147 FERS RETIREMENT	819,740
	12148 TSP	297,514
	12149 401K CONT	310,642
	12511 CASH AWARDS	17,500
	12620 TRAVEL BONUS	23,000
		2,496,571
TRAVEL EXPENSES	22000 POV	32,928
	24000 PER DIEM/LODGING	567,300
	26000 AIR FARES	224,100
	28000 AUTO RENTALS	16,325
	29000 OTHER TRAVEL COSTS	14,400
		855,053
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	12,600
	33000 MISC RENTALS	4,500
		17,100
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	10,500
	43200 SUBS/PUBS	60,000
	43700 REFRESHMENTS/OUTREACH	2,500
	49840 FFIEC	180,000
		253,000
CONTRACTED SERVICES	59230 M/S TRAINING	10,500
	59240 NON-SUPER TRAINING	96,000
	59999 MISC CONT SVCS	1,225,000
		1,331,500
		11,374,469

2015 Office of General Counsel Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	4,469,097
	11150 PART-TIME SALARY	309,332
		4,778,430
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	48,695
	12142 HEALTH BENEFITS	260,152
	12143 LIFE INSURANCE	9,638
	12144 OASDI/MEDICARE	261,814
	12145 VISION AND DENTAL	23,760
	12147 FERS RETIREMENT	538,927
	12148 TSP	202,390
	12149 401K CONT	200,694
	12511 CASH AWARDS	13,300
		1,559,370
TRAVEL EXPENSES	22000 POV	5,000
	24000 PER DIEM/LODGING	70,000
	26000 AIR FARES	60,000
	28000 AUTO RENTALS	5,500
	29000 OTHER TRAVEL COSTS	15,000
		155,500
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	900
	33000 MISC RENTALS	1,000
		1,900
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	1,000
	43200 SUBS/PUBS	10,000
		11,000
CONTRACTED SERVICES	56900 LEGAL FEES	175,000
	59230 M/S TRAINING	1,000
	59240 NON-SUPER TRAINING	15,000
	59999 MISC CONT SVCS	34,000
		225,000
		6,731,200

2015 Office of Human Resources Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	5,508,329
	11200 OVERTIME	5,000
		5,513,329
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	64,973
	12142 HEALTH BENEFITS	379,556
	12143 LIFE INSURANCE	12,666
	12144 OASDI/MEDICARE	322,537
	12145 VISION AND DENTAL	32,472
	12147 FERS RETIREMENT	604,580
	12148 TSP	216,032
	12149 401K CONT	231,350
	12511 CASH AWARDS	19,500
	12512 ON THE SPOT AWDS	200,500
	12513 AWARD CEREMONY	15,000
	12620 TRAVEL BONUS	22,500
	12631 WKRS COMP	225,000
	12632 UNEMP COMP	35,000
	12950 HEALTH MAINT	72,525
	12980 OTHER PERS SVCS	3,000
		2,457,191
TRAVEL EXPENSES	22000 POV	23,016
	24000 PER DIEM/LODGING	2,237,361
	26000 AIR FARES	157,250
	28000 AUTO RENTALS	39,600
	29000 OTHER TRAVEL COSTS	38,350
		2,495,577
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	1,150
	31500 TELEPHONE	1,700
	33000 MISC RENTALS	243,200
	34100 POSTAGE	300
		246,350
ADMINISTRATIVE	42000 PRINTING	1,000
	43000 SUPPLIES/MATERIALS	40,750
	43200 SUBS/PUBS	18,525
	43700 REFRESHMENTS/OUTREACH	226,400
	49400 RECRUITMENT/ADV	229,332
	49840 FFIEC	339,376
	49999 MISC ADMIN OTHER	47,655
		903,038
CONTRACTED SERVICES	55700 INV/GRIEVANCES	25,000
	55900 CONSULTING	2,265,307
	58000 ACCTG/PAYROLL/HR	220,000
	59230 M/S TRAINING	210,500
	59240 NON-SUPER TRAINING	125,700
	59999 MISC CONT SVCS	153,838
		3,000,345
		14,615,830

2015 Office of Public and Congressional Affairs Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	990,533
		990,533
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	17,644
	12142 HEALTH BENEFITS	66,318
	12143 LIFE INSURANCE	2,068
	12144 OASDI/MEDICARE	53,888
	12145 VISION AND DENTAL	5,544
	12147 FERS RETIREMENT	97,479
	12148 TSP	31,582
	12149 401K CONT	41,602
	12511 CASH AWARDS	3,000
		319,125
TRAVEL EXPENSES	22000 POV	2,100
	24000 PER DIEM/LODGING	3,800
	26000 AIR FARES	6,000
	28000 AUTO RENTALS	500
	29000 OTHER TRAVEL COSTS	1,500
		13,900
ADMINISTRATIVE	43000 SUPPLIES/MATERIALS	2,500
	43200 SUBS/PUBS	20,627
	43700 REFRESHMENTS/OUTREACH	1,250
	49220 REP EXPENSES	2,500
	49999 MISC ADMIN OTHER	2,100
		28,977
CONTRACTED SERVICES	55900 CONSULTING	12,000
	59240 NON-SUPER TRAINING	21,000
	59600 TEMPORARY LABOR	25,000
	59999 MISC CONT SVCS	412,700
		470,700
		1,823,235

2015 Region 1 Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	17,692,478
	11150 PART-TIME SALARY	159,903
	11200 OVERTIME	12,000
		17,864,381
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	79,929
	12142 HEALTH BENEFITS	1,410,587
	12143 LIFE INSURANCE	44,026
	12144 OASDI/MEDICARE	1,211,364
	12145 VISION AND DENTAL	135,432
	12147 FERS RETIREMENT	2,205,790
	12148 TSP	777,510
	12149 401K CONT	749,800
	12511 CASH AWARDS	84,500
	12620 TRAVEL BONUS	101,900
	12950 HEALTH MAINT	4,000
		6,804,839
TRAVEL EXPENSES	22000 POV	946,951
	24000 PER DIEM/LODGING	1,885,719
	26000 AIR FARES	660,219
	28000 AUTO RENTALS	90,696
	29000 OTHER TRAVEL COSTS	201,008
		3,784,593
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	12,830
	31500 TELEPHONE	19,000
	32100 SPACE RENTAL	196,186
	33000 MISC RENTALS	58,905
	34100 POSTAGE	3,946
		290,867
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	8,300
	42000 PRINTING	2,375
	43000 SUPPLIES/MATERIALS	92,900
	43200 SUBS/PUBS	3,751
	43700 REFRESHMENTS/OUTREACH	28,516
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	17,000
	49610 CREDIT REPORTS	485
	49999 MISC ADMIN OTHER	2,000
		155,627
CONTRACTED SERVICES	52290 EQUIP REPAIR/MAINT	7,215
	55900 CONSULTING	22,750
	59230 M/S TRAINING	21,491
	59240 NON-SUPER TRAINING	49,412
	59999 MISC CONT SVCS	17,700
		118,568
		29,018,875

2015 Region 2 Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	18,886,084
	11200 OVERTIME	8,000
		18,894,084
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	72,816
	12142 HEALTH BENEFITS	1,638,925
	12143 LIFE INSURANCE	44,632
	12144 OASDI/MEDICARE	1,295,045
	12145 VISION AND DENTAL	138,600
	12147 FERS RETIREMENT	2,355,653
	12148 TSP	847,232
	12149 401K CONT	793,216
	12511 CASH AWARDS	86,500
	12620 TRAVEL BONUS	115,000
	12950 HEALTH MAINT	3,500
		7,391,118
TRAVEL EXPENSES	22000 POV	922,270
	24000 PER DIEM/LODGING	1,684,779
	26000 AIR FARES	351,088
	28000 AUTO RENTALS	36,972
	29000 OTHER TRAVEL COSTS	218,324
		3,213,433
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	9,760
	31500 TELEPHONE	21,600
	32100 SPACE RENTAL	497,672
	33000 MISC RENTALS	29,150
	34100 POSTAGE	1,708
		559,890
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	8,000
	43000 SUPPLIES/MATERIALS	133,700
	43200 SUBS/PUBS	6,687
	43700 REFRESHMENTS/OUTREACH	26,645
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	5,750
	49610 CREDIT REPORTS	1,000
	49999 MISC ADMIN OTHER	2,800
		184,882
CONTRACTED SERVICES	52290 EQUIP REPAIR/MAINT	2,000
	55900 CONSULTING	75,000
	59230 M/S TRAINING	41,114
	59240 NON-SUPER TRAINING	70,338
	59999 MISC CONT SVCS	6,162
		194,614
		30,438,021

2015 Region 3 Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	17,840,004
		17,840,004
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	34,133
	12142 HEALTH BENEFITS	1,641,200
	12143 LIFE INSURANCE	42,395
	12144 OASDI/MEDICARE	1,257,020
	12145 VISION AND DENTAL	136,224
	12147 FERS RETIREMENT	2,290,515
	12148 TSP	823,371
	12149 401K CONT	749,280
	12511 CASH AWARDS	85,000
	12620 TRAVEL BONUS	216,050
		7,275,188
TRAVEL EXPENSES	22000 POV	1,056,680
	24000 PER DIEM/LODGING	2,419,320
	26000 AIR FARES	772,805
	28000 AUTO RENTALS	102,260
	29000 OTHER TRAVEL COSTS	152,470
		4,503,535
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	12,000
	31500 TELEPHONE	12,815
	32100 SPACE RENTAL	312,900
	33000 MISC RENTALS	31,000
	34100 POSTAGE	1,725
		370,440
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	16,200
	43000 SUPPLIES/MATERIALS	101,025
	43200 SUBS/PUBS	500
	43700 REFRESHMENTS/OUTREACH	26,380
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	18,000
	49610 CREDIT REPORTS	500
	49999 MISC ADMIN OTHER	22,200
		185,105
CONTRACTED SERVICES	52110 SPACE REPAIRS/ALT	1,000
	52290 EQUIP REPAIR/MAINT	10,448
	55900 CONSULTING	94,500
	59230 M/S TRAINING	23,400
	59240 NON-SUPER TRAINING	62,000
		191,348
		30,365,620

2015 Region 4 Budget

Groupings	Cost Element	Annual Budget
EMPLOYEE PAY	11110 REGULAR SALARY	18,039,945
	11150 PART-TIME SALARY	70,557
	11200 OVERTIME	6,500
		18,117,001
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	63,301
	12142 HEALTH BENEFITS	1,673,250
	12143 LIFE INSURANCE	42,176
	12144 OASDI/MEDICARE	1,249,163
	12145 VISION AND DENTAL	140,184
	12147 FERS RETIREMENT	2,271,219
	12148 TSP	808,675
	12149 401K CONT	760,641
	12511 CASH AWARDS	87,500
	12620 TRAVEL BONUS	265,210
	12950 HEALTH MAINT	2,500
		7,363,818
TRAVEL EXPENSES	22000 POV	999,186
	24000 PER DIEM/LODGING	2,916,009
	26000 AIR FARES	871,746
	28000 AUTO RENTALS	268,468
	29000 OTHER TRAVEL COSTS	196,944
		5,252,353
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	12,000
	31500 TELEPHONE	14,400
	32100 SPACE RENTAL	108,850
	33000 MISC RENTALS	34,028
	34100 POSTAGE	2,243
		171,521
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	9,865
	42000 PRINTING	400
	43000 SUPPLIES/MATERIALS	97,954
	43200 SUBS/PUBS	1,669
	43700 REFRESHMENTS/OUTREACH	38,940
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	27,400
	49610 CREDIT REPORTS	250
	49999 MISC ADMIN OTHER	3,600
		180,378
CONTRACTED SERVICES	52290 EQUIP REPAIR/MAINT	7,121
	59230 M/S TRAINING	28,678
	59240 NON-SUPER TRAINING	86,421
	59999 MISC CONT SVCS	41,977
		164,197
		31,249,269

2015 Region 5 Budget

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	18,525,376
	11200 OVERTIME	10,300
	11950 OUT OF USA DIFF	136,104
		18,671,780
EMPLOYEE BENEFITS	12141 CIVIL SERVICE RETMT	34,432
	12142 HEALTH BENEFITS	1,508,051
	12143 LIFE INSURANCE	41,278
	12144 OASDI/MEDICARE	1,262,820
	12145 VISION AND DENTAL	135,940
	12147 FERS RETIREMENT	2,380,420
	12148 TSP	835,252
	12149 401K CONT	778,546
	12511 CASH AWARDS	84,000
	12620 TRAVEL BONUS	227,000
	12950 HEALTH MAINT	4,000
		7,291,739
TRAVEL EXPENSES	22000 POV	625,687
	24000 PER DIEM/LODGING	2,836,984
	26000 AIR FARES	1,167,974
	28000 AUTO RENTALS	256,910
	29000 OTHER TRAVEL COSTS	279,136
		5,166,690
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	10,860
	31500 TELEPHONE	8,300
	32100 SPACE RENTAL	365,000
	33000 MISC RENTALS	57,300
	34100 POSTAGE	2,755
		444,215
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	8,000
	42000 PRINTING	500
	43000 SUPPLIES/MATERIALS	96,000
	43200 SUBS/PUBS	3,000
	43700 REFRESHMENTS/OUTREACH	47,000
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	37,725
	49610 CREDIT REPORTS	700
	49999 MISC ADMIN OTHER	3,610
		196,835
CONTRACTED SERVICES	52110 SPACE REPAIRS/ALT	3,500
	52290 EQUIP REPAIR/MAINT	15,000
	59230 M/S TRAINING	21,000
	59240 NON-SUPER TRAINING	60,000
	59999 MISC CONT SVCS	12,200
		111,700
		31,882,959

2015 Asset Management and Assistance Center

		Annual Budget
Groupings	Cost Element	
EMPLOYEE PAY	11110 REGULAR SALARY	4,218,464
	11200 OVERTIME	65,000
	11910 VACANCY DIFFERENTIAL	-200,000
		4,083,464
EMPLOYEE BENEFITS	12142 HEALTH BENEFITS	384,337
	12143 LIFE INSURANCE	8,668
	12144 OASDI/MEDICARE	292,426
	12145 VISION AND DENTAL	30,096
	12147 FERS RETIREMENT	556,837
	12148 TSP	194,702
	12149 401K CONT	177,175
	12511 CASH AWARDS	18,000
	12950 HEALTH MAINT	5,000
		1,667,242
TRAVEL EXPENSES	22000 POV	7,000
	24000 PER DIEM/LODGING	100,000
	26000 AIR FARES	81,000
	28000 AUTO RENTALS	14,000
	29000 OTHER TRAVEL COSTS	10,000
		212,000
RENT/COM/UTILITIES	31100 EMPLOYEE PHONE	400
	31500 TELEPHONE	82,600
	32100 SPACE RENTAL	110,250
	33000 MISC RENTALS	1,500
		194,750
ADMINISTRATIVE	41000 SHIPPING/DELIVERY	1,000
	42000 PRINTING	750
	43000 SUPPLIES/MATERIALS	49,000
	43200 SUBS/PUBS	32,200
	43700 REFRESHMENTS/OUTREACH	10,600
	49220 REP EXPENSES	300
	49400 RECRUITMENT/ADV	2,500
	49999 MISC ADMIN OTHER	6,000
		102,350
CONTRACTED SERVICES	52110 SPACE REPAIRS/ALT	2,500
	52290 EQUIP REPAIR/MAINT	95,000
	56900 LEGAL FEES	1,000
	59230 M/S TRAINING	10,000
	59240 NON-SUPER TRAINING	45,000
		153,500
		6,413,306

Transfer Pricing

Overhead Transfer Rate Review

For National Credit Union Administration

Issued: January 20, 2011
Prepared by: PRICEWATERHOUSECOOPERS

Table of Contents

1. Executive Summary

1.1. Purpose of Analysis

PricewaterhouseCoopers LLP ("PwC", "us" or "we") has been engaged by the National Credit Union Administration ("NCUA") to evaluate the Overhead Transfer Rate ("OTR") administered between the National Credit Unit Administration Operating Fund ("NCUAOF") and the National Credit Union Share Insurance Fund ("NCUSIF"). The OTR is one of two sources of funding for NCUA's operating budget and is intended to transfer "insurance-related" expenses of NCUAOF to NCUSIF.[1]

This study and its conclusions are limited to the evaluation of the reasonableness and soundness of the methodology adopted by NCUA in the calculation and administration of the OTR given NCUA's dual role as regulator and insurer. This study does not express an opinion related to any issues that may be perceived with regards to NCUA's dual role as regulator and insurer, oversight or lack thereof of NCUA's budget or an interpretation of Congressional intent behind Title II of the Federal Credit Union Act of 1970 which established NCUSIF.

1.2. Overview of Analysis

To complete this study PwC undertook the following steps:

1) Conducted interviews with and requested key information from NCUA personnel deemed to be relevant for purposes of developing a comprehensive understanding of the methodology currently employed by NCUA in the calculation of the OTR (the "OTR Methodology") including details and assumptions underlying various steps;
2) Identified and conducted interviews with "key stakeholders" in the U.S. credit union system that included credit unions and trade associations for federal and state chartered credit unions as well as that for the state regulatory authorities;
3) Identified the stakeholders' views on attributes that a sound OTR Methodology should possess as well as the concerns and issues with regards to the current OTR Methodology as perceived by the stakeholders;
4) Developed a set of criteria to evaluate the current OTR Methodology based on the concerns and issues identified by the key stakeholders; and,
5) Evaluated NCUA's current OTR Methodology against the set of criteria so as to arrive at a conclusion of the soundness and reasonableness of the current OTR Methodology and develop recommendations and suggestions for improvement.

1.3. Scope of Opinion

The services were performed, and this study prepared, at the direction of and in accordance with instructions provided by NCUA, exclusively for the sole benefit of and use by NCUA. The services and study are not intended for, nor may they be relied upon by any other party. This study and its contents may not be distributed to, discussed with, or otherwise disclosed to any third party without PwC's prior written consent. This study is not to be referred to or quoted, in whole or in part, in any

[1] The other source being the operating fees collected from federally chartered credit unions.

offering memorandum, prospectus, registration statement, public filing, loan or other agreement or document without our express written approval, which may require that we perform additional work.

PwC accepts no duty, obligation, liability or responsibility to any party, other than NCUA, with respect to the services and/or this study. PwC makes no representation regarding the sufficiency of the services for any purpose.

The underlying prospective financial information referred to in this study, unless otherwise referenced, was prepared and developed by NCUA management. PwC did not prepare any prospective financial information nor develop any assumptions therein. It is NCUA's responsibility to consider our comments and make its own decisions based on the information available to it. Because events and circumstances frequently do not occur as expected, there will usually be differences between predicted and actual results, and those differences may be material. We take no responsibility for the achievement of predicted results.

1.4. Summary of Conclusions

As part of the analysis conducted for this study, PwC performed interviews with personnel from NCUA and other stakeholders in the U.S. credit union system, including, but not limited to:

- Personnel from the NCUA Office of Examination & Insurance who are associated with and have knowledge of the design and implementation of the OTR Methodology.
- A Senior Principal Examiner who also has experience with the Examination Time Survey used as a key input to the OTR Methodology. A Principal Examiner is generally an experienced examiner who has been involved in examination reviews and field examinations for federally insured credit unions.
- Identified stakeholders in the credit union system (referred to as the "key stakeholders" in this study) that include industry groups such as the Credit Union National Association ("CUNA"), the National Association of Federal Credit Unions ("NAFCU"), and the National Association of State Credit Union Supervisors ("NASCUS"). Both CUNA and NAFCU are trade associations that service the needs and operations of credit unions. CUNA is associated with both federal and state credit unions, and NAFCU is associated with federal credit unions only. The third industry group, NASCUS, is an association for the state supervisors who oversee the operation of the state chartered credit unions. PwC also interviewed management personnel from the third largest federally insured credit union, the Boeing Employees Credit Union ("BECU"), which is a state chartered credit union.

In conjunction with the interviews, PwC obtained and studied the following documents that were made available to it by one or more of the parties mentioned above or located in the public domain to develop a comprehensive understanding of the history, constituent steps, assumptions and data sources associated with the current OTR Methodology:

- 2008 and 2009 Overhead Transfer Rate Board Action Memorandum: The Office of Examination and Insurance at NCUA presents the 2009 and 2010 recommended OTR to the NCUA Board for approval in the 2008 and 2009 OTR Board Action Memorandum, respectively;
- 2003 Overhead Transfer Rate Task Force Proposal: This is the proposal submitted by a five member NCUA Task Force that was formed in 2003 to review the OTR Methodology;
- 2001 Overhead Transfer Rate Review Report prepared by Deloitte & Touche;
- 2001 paper on OTR titled "Caught in a Regulatory Vise: The Peculiar Problem Faced by Federally Insured State-Chartered Credit Unions" by Lawrence White, received from BECU;
- 2001 white paper received from NASCUS titled "Restructuring the NCUA";
- Government Accountability Office ("GAO") 2003 report on credit unions;
- 2007 NCUA Annual Report;
- NCUA organizational charts;

- 2007 revised Federal Credit Union Act;
- Data on the credit union system from the 2010 Statistical Abstract, U.S. Census Bureau.

Based on the interviews and the aforementioned material, PwC identified the following criteria for purposes of evaluating the current OTR Methodology and recommending possible refinements for NCUA's consideration:

1) Transparency - The OTR Methodology and its underlying steps, assumptions and data sources should be communicated clearly and regularly to stakeholders in the credit union system so as to develop broad and consistent understanding among stakeholders. Of fundamental importance to the computation of the OTR is the distinction between activities and associated expenses deemed to be in keeping with NCUA's role in managing the NCUSIF (i.e., expenses that can be characterized as being "insurance-related" and thus included in the OTR) and others classified as those in keeping with NCUA's role as regulator (and thus excluded from the OTR). Given this, the OTR Methodology should be based on a classification that represents a consensus (among NCUA and other stakeholders in the credit union system) with regards to the classification of such activities.
2) Accuracy - Subject to the classification of activities as insurance and regulatory-related, the calculation of the OTR should be predicated on a methodology that is able to measure and track the expenses associated with such activities accurately and consistently across different parts of the organization and over time.
3) Equity - The calculation and administration of the OTR should not, ex-ante and for reasons beyond the control of the credit unions, favour or disadvantage one type of credit unions (i.e. federal versus state chartered) over another.
4) Reasonable administrative burden - The OTR Methodology needs to be such as to balance the objectives of criterion 1 through 3 while keeping costs of implementation manageable.

The findings and conclusions of this study, which are based on an analysis of available facts and circumstances, are presented below.

1.4.1. Transparency

Based on PwC's review, the OTR Methodology was considered lacking in terms of the extent to which the classification of NCUA's activities between insurance and regulatory (upon which the methodology is fundamentally dependent) represents a consensual view on such classifications in the industry. Further, there was found to be dissatisfaction within the industry with respect to NCUA's efforts to communicate and explain the OTR Methodology in adequate detail.

It is recommended that NCUA should consider providing more visibility on how it characterizes its activities to the different industry groups and credit unions and possibly solicit their feedback with regards to the reasonableness and accuracy of the classification. NCUA should also consider steps aimed at making the methodology itself more transparent, along with all of the assumptions and steps that are utilized. Possible ways of achieving this include more frequent interactions with the stakeholders through different channels (e.g. meeting, publications, etc.).

1.4.2. Accuracy

PwC analyzed the following five elements from the perspective of their ability to accurately and consistently "measure" the expenses associated with the management of NCUSIF and incurred on behalf of all federally-insured credit unions:

1.4.2.1 Implementation of Examination Time Survey - Education and Training of Examiners

Based on PwC's review, the current definition of insurance and regulatory activities is appropriately communicated to the examiners through well-structured tools and training modules. The process provides enough resources for examiners to learn how to fill the Examination Time Survey properly.

1.4.2.2. Examination Time Survey Reliability

Based on PwC's review, the statistical methodology used by NCUA to estimate the non-insurance percentage of workload hours for each program in order to determine the OTR can be considered reasonable. While the sampling methodology obtains representation across regions, Supervisory Examiner Groups, Principal Examiners, work hours and federal credit unions it can be improved with respect to the representativeness of the distribution of credit unions by asset size in the sample relative to the population.

In order to obtain a more representative sample, it is recommended that some consideration of sample allocation by asset size and CAMEL rating should be taken into account as there appears to be some correlation between these characteristics and the percent of "insurance-related" work hours.[2] Additionally, it is recommended that NCUA use sample sizes that are consistent with the calculated sample sizes for the two main types of activities (i.e. programs) under survey, and specifically, that NCUA consider increasing the sample sizes for the Federal Supervision (Code 22) Program.

1.4.2.3. Other Allocation Factors

Based on PwC's review, the allocation factors used to determine the insurance/regulatory percentage of costs for certain NCUA cost centers (i.e., the Division of Insurance and NCUA's central offices which are referred to as "Other NCUA Cost Centers" and these allocation factors are referred to as "Other Allocation Factors") were found to be based on methods that are less objective and verifiable as compared to the Examination Time Survey results used to determine the equivalent split for examiner costs. Given that costs for Other NCUA Cost Centers constitute a significant portion of NCUA's overall budget, the final OTR as determined based on these Other Allocation Factors as an input can potentially be "distorted".

It is recommended that NCUA consider adopting a more formal and documented process for determining the Other Allocation Factors that are based on a standard and consistent criteria.

1.4.2.4. Imputed State Supervisory Authority Value Calculation

Based on PwC's review, the exclusion of an estimate of "overhead-type costs" that State Supervisory Authorities ("SSAs") incur in their performance of "insurance-related" activities can lead to a potential underestimation of the Imputed SSA Value relative to the actual "insurance-related" costs incurred by the SSAs and borne by Federally Insured State Credit Unions ("FISCUs") through the operating fees paid by them. Application of the overall percent of "insurance-related" hours based on the Examination Time Survey implemented for Federal Credit Unions ("FCUs") to the total examination hours imputed for FISCUs in order to calculate an estimate of the total "insurance-related" hours for FISCUs was found to be reasonable given that the distributions of FCUs and FISCUs across asset sizes and CAMEL ratings is not dissimilar.

It is recommended that the Imputed SSA Value should reflect an estimate of the "insurance-related" costs incurred by SSAs and borne by the FISCUs through the operating fees paid by them. An estimate of SSA overhead-type costs should be incorporated in the current calculation of the Imputed SSA Value. The estimate of SSA overhead-type costs could be estimated as a percentage of the current Imputed SSA Value based on a corresponding figure for NCUA.

1.4.2.5. Insured Asset Shares

Based on PwC's review, the use of the share of insured assets as the basis to allocate the insurance costs between FCUs and FISCUs was found to be reasonable and appropriate.

[2] The CAMEL rating system, which refers to the adequacy of Capital, the quality of Assets, the capability of Management, the quality and level of Earnings, and the adequacy of Liquidity, is used for purposes of assessing the riskiness of credit unions and classifying credit unions based on that measurement.

1.4.3. Equity

Based on PwC's review, there was no reasonable basis to conclude that the OTR methodology ex-ante and for reasons beyond the control of credit unions, favours or disadvantages any one type of credit unions (i.e. federal versus state chartered) over another.

1.4.4. Reasonable Administrative Burden

Based on PwC's review, even though the calculation methodology is a multi-layered complex algorithm, the costs and burdens of implementation were not viewed by management as significant impediments.

1.5. Organization of Study

This rest of the study is organized as follows:

- Section 2 - "Background": This section contains an overview of background information on which the study is based, including an overview of NCUA financing structure and the OTR.
- Section 3 - "Overview of Existing OTR Computation and Administration": This section contains an overview of the current OTR Methodology, with a discussion of the underlying steps, assumptions and data sources.
- Section 4 - "Methodology": This section contains a description of the methodology that PwC adopted for purposes of this study.
- Section 5 - "Economic Analysis": This section contains PwC's review of NCUA's existing OTR Methodology based on the identified evaluation criteria.
- Section 6 - "Conclusions": This section contains our conclusions.

2. Background

2.1. NCUA

NCUA is an independent federal agency that charters and supervises credit unions throughout the United States and its territories. In accordance with the Federal Credit Union Act introduced in 1934 by the Congress, NCUA aims to serve, protect and promote a safe, stable national system of cooperative financial institutions that encourage thrift and offer a source of credit for their members. NCUA also administers NCUSIF, which was created in 1970, under Section 1783 of the Federal Credit Union Act, as an insurance fund to provide insurance protection to all the account holders in all federally insured credit union.

Consequently, NCUA performs a dual role - it is the charterer and primary regulator of credits unions (specifically the federally chartered credit unions) and has broad safety-and-soundness regulatory powers for all credit unions (including the state chartered credit unions) whose deposits/credit shares are insured by NCUSIF. This dual role as a regulator and an insurer puts NCUA in a unique position that is unlike any other federal or state agency in the United States.

2.2. Credit Union System

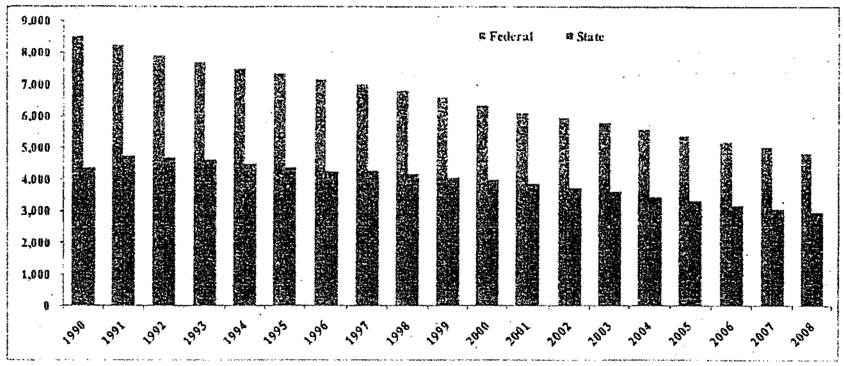
A credit union is a cooperative financial institution that is owned and controlled by its members and operated for the purpose of promoting thrift, providing credit at reasonable rates, and providing other financial services to its members. In the United States, credit unions can be chartered by either the federal government through NCUA (i.e. the federal credit unions), or by the state governments through the SSAs (i.e. the state chartered credit unions). This system of having both federal and state chartered credit unions is called "dual chartering". Financial institutions in the United States have a long history of dual chartering; the three major categories of depository institutions, commercial banks, savings banks and credit unions, have federal and state chartering agencies. Dual chartering for commercial banks began in 1863; it was extended to savings and loan institutions in 1933, and with the announcement of the Federal Credit Union Act in 1934, dual chartering was extended to the credit union system.

The dual chartering system is viewed by many as a system of implicit competition between the two types of charters, with the states and federal regulatory bodies offering charters with different attributes and incentives. This is viewed as ensuring that the credit union industry is diverse and constantly evolving as competition for membership between the regulatory authorities promotes innovation. It also provides regulators incentive to increase efficiency and reduce their costs.

Over the last two decades, the number of credit unions, both federal and state chartered, has gone down, federal credit unions experiencing a larger decline in numbers than the state chartered credit unions. However, the proportion of federal credit unions in the system has been relatively stable across these years. Federal credit unions have accounted for about 62 percent of all credit unions while state chartered credit unions accounted for the remaining 38 percent over the 1990 - 2008 period. Figure 1 below illustrates the trend in the absolute number of credit unions, federal and state chartered, over the last two decades.

Background

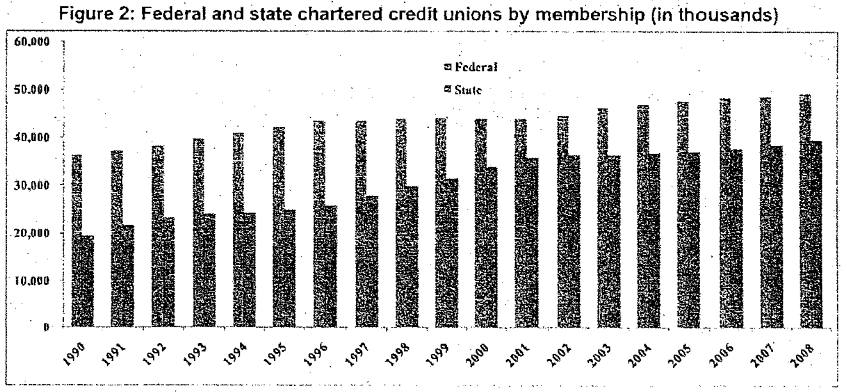
Figure 1: Number of federal and state chartered credit unions



Source: PwC analysis based on the 2010 Statistical Abstract, U.S. Census Bureau

During the same time period, the number of members enlisted under both federal and state chartered credit unions has increased steadily, with the increase in membership for state chartered credit unions outpacing the increase in federal credit unions. The state chartered credit unions share of membership has also increased during this time period from about 35 percent in 1990 to 45 percent in 2008, whereas that of the federally chartered credit unions has gone down from 65 percent in 1990 to 55 percent in 2008. Figure 2 below illustrates the trend in membership for federal and state chartered credit unions over the last two decades.

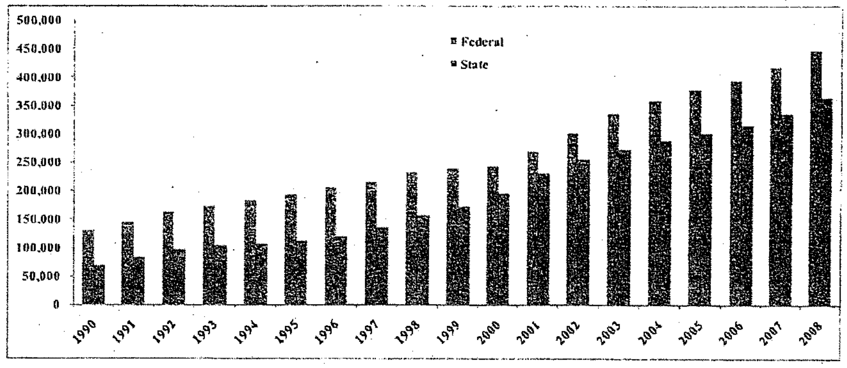
Figure 2: Federal and state chartered credit unions by membership (in thousands)



Source: PwC analysis based on the 2010 Statistical Abstract, U.S. Census Bureau

The total assets under management in both federal and state chartered credit unions have also increased over this period, with the increase in total assets for state chartered credit unions being slightly higher than that of the federal credit unions. The state chartered credit unions share of total assets increased during this time period from about 34 percent in 1990 to 45 percent in 2008, whereas that of the federally chartered ones has gone down from 66 percent in 1990 to 55 percent in 2008. Figure 3 below illustrates the trend in total assets under management at federal and state chartered credit unions, over the last two decades.

Figure 3: Federal and state chartered credit unions by total assets (in USD millions)



Source: PwC analysis based on the 2010 Statistical Abstract, U.S. Census Bureau

Similar to other sectors in the economy, the recent economic downturn over the last couple of years has adversely affected the credit union system. The biggest impact of the recession has been the losses that the credit unions have incurred from home mortgage delinquencies. The number of credit union closures has also increased, which has elevated the need for increased safety-and-soundness reviews from the regulatory agencies. As an insurer of federal insured credit unions, NCUSIF is obligated if a federal insured credit union fails to perform. Therefore, industry risks associated with the credit union business also affect NCUSIF. The federal insured credit unions with questionable business practices require NCUSIF to book a reserve for the identified and anticipated losses from credit unions' failures.[3] NCUSIF recorded a $758.7 million reserve for losses as of December 31, 2009 and $278.3 million as of December 31, 2008.[4]

2.3. NCUA Financing Structure

Under the Federal Credit Union Act of 1934, NCUAOF was created as a revolving fund in the United States Treasury under the management of the NCUA Board. This fund was intended to assist NCUA in providing administration and service to the federal credit union system and coordinating required supervisory involvement with the state charting authority for state-chartered credit unions insured by NCUSIF. With the backing of the full faith and credit of the U.S. government, NCUA administers the NCUSIF, which insures the savings of more than 90 million account holders in all federal credit unions and the substantial majority of state-charted credit unions.

NCUAOF is financed through two sources. First, all FCUs are assessed an annual fee that is based on the credit union's asset size as of December 31 of the prior year. This fee is designed to cover the costs of providing administration and services, as well as regulatory examinations to the federal credit union system. In addition, the Federal Credit Union Act authorizes NCUA to expend funds from the NCUSIF for administrative and other expenses related to the insurance activities performed for all federally insured credit unions, including the FCUs and FISCUs. These funds are transferred through the OTR and accounts for a substantial portion of funding for NCUAOF.

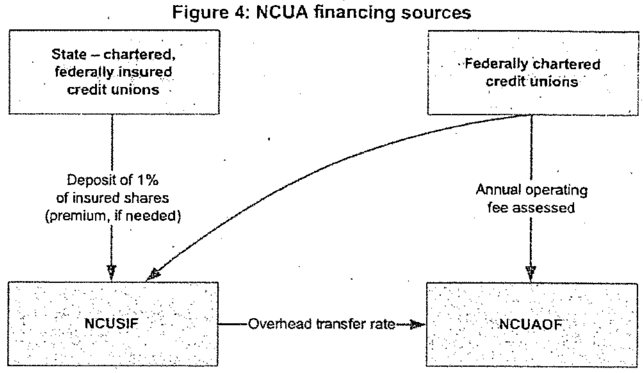
To implement the OTR, NCUA needs to allocate the operating costs between insurance (safety-and-soundness) and non-insurance (regulatory/compliance/legal issues) related activities that its staff performs. The NCUA Board reviews this OTR fee structure annually and, in order to meet the requirements of stakeholders, NCUA must evaluate the components and calculation methodology used to determine the OTR to provide greater equity and accuracy in allocating the NCUAOF

[3] Credit unions experiencing financial difficulty are identified through the NCUA supervision and examination process. NCUSIF then determines the estimated losses from such credit unions.

[4] NCUSIF Financial Statements for the year ended December 31, 2009.

overhead costs in accordance with the Federal Credit Union Act. Figure 4 below illustrates the financing sources of NCUSIF and NCUAOF.

Figure 4: NCUA financing sources



2.3.1. Overhead Transfer Rate

NCUA is both a regulator and an insurer. Shortly after the creation of NCUSIF, GAO, in 1972, identified the need to allocate costs between these two roles. Section 1783 of the Federal Credit Union Act depicts the following:

> *"**1783(a)** There is hereby created in the Treasury of the United States a National Credit Union Share Insurance Fund which shall be used by the Board as a revolving fund for carrying out the purposes of this title. Money in the fund shall be available upon requisition by the Board, without fiscal year limitation, for making payments of insurance under section 207 of this title, for providing assistance and making expenditures under section 208 of this title in connection with the liquidation or threatened liquidation of insured credit unions, <u>and for such administrative and other expenses incurred in carrying out the purposes of this title as it may determine to be proper</u>." - Title II*

For this purpose, the Federal Credit Union Act authorizes NCUA to expend funds from NCUSIF for administrative and other expenses related to the insurance activities. This overhead transfer from NCUSIF for insurance services provides a substantial portion of funding for NCUAOF.

2.3.2 NCUA Insurance and Regulatory Activities

While NCUA's role as a regulator is limited to FCUs, its role as an insurer encompasses FCUs as well as FISCUs. NCUA performs its insurance and regulatory functions mainly through examination reviews of federally insured credit unions. With respect to FCUs, NCUA views these examination reviews serving the dual purpose of ensuring regulatory compliance as is consistent with its regulatory role as well as performing "safety-and-soundness" assessments of these credit unions in keeping with its role as the insurer. The examination reviews of FISCUs, which are conducted by NCUA in collaboration with the relevant SSAs, are limited purely to "safety-and-soundness" issues given that NCUA does not have regulatory purview over these credit unions. Thus, collectively through the examination reviews, NCUA assesses if a particular credit union is compliant with rules and regulations that apply to federally chartered credit unions and if the credit union poses risks to the NCUSIF.

In the course of their examination reviews, NCUA examiners focus on the following seven "risk areas":

- Credit Risk – the risk of non-repayment of loans and investments undertaken by the credit union;

- Interest Rate Risk – the risk that the credit union fails to adequately manage changes in market interest rates to maintain an appropriate net interest margin;
- Liquidity Risk – the risk that the credit union will not be able to liquidate assets quickly and with minimal loss in value;
- Transaction Risk – the risk that fraud or errors will cause a loss to the credit union;
- Compliance Risk – the risk that the credit union will fail to comply with laws and regulations, prudent ethical standards, and contractual obligations;
- Strategic Risk – the risk that poor business decisions or improper implementation of strategic goals will reduce the credit union's earnings and net worth; and
- Reputation Risk – the risk that the credit union's public image will be tarnished due to improper actions on the part of officials, management, or staff.

The NCUA examiners as well as the state examiners employ a common automated platform - AIRES which stands for Automated Integrated Regulatory Examination Software - to collect, analyze and report information as part of their examination of credit unions. The insurance functions completed for both FCUs and FISCUs are similar in nature and are based on assessment of risk to NCUSIF, which entails evaluating the seven risk factors mentioned above.

2.3.3. OTR History

In 1972 GAO recommended that "insurance-related" and regulatory related costs be allocated between NCUA and NCUSIF. In the following years until 1980, various cost allocation methodologies were implemented by NCUA, including direct charges to NCUSIF for insurance expenses (e.g. cost of closing institutions, liquidation and merger costs, etc.), and time spent by examiners on supervising (as opposed to examining) institutions. Over the 1981 to 1984 period, the OTR ranged between 30 and 34 percent.

From 1985 through 1994, NCUA's Office of Examination and Insurance ("E&I") conducted annual studies to determine an appropriate factor for allocating NCUA's total operating expenses between the "insurance-related" and regulatory related activities. E&I designed examiner survey forms to determine the percent of time devoted to regulatory-related and "insurance-related" issues. During this period, E&I used the following process to gather empirical data:

- E&I had all NCUA examiners complete survey forms for each federal credit union examination completed during a certain time period;
- The survey forms captured the examiners' estimates of the hours spent on completing various examination scope components; and
- The examiners submitted the survey forms, and E&I compiled the data and developed a recommendation to the NCUA Board.

During this ten year period, the survey results on the percent of insurance-related hours varied between 50.1 percent and 60.4 percent; however, the OTR was maintained at 50 percent. From 1994 to 2000, based on E&I recommendations, the OTR was kept at 50 percent by NCUA. In 2000, the scope and methodology of the examiner survey was revised to include principal examiners, regional staff, and central office staff. The surveys resulted in "insurance-related" percentages for each group which resulted in a weighted average OTR of 66.72 percent.

Following the increase in OTR from 50 percent to 66.72 percent, in 2001, Deloitte and Touche was engaged to complete a study on the cost allocation process. The study included recommendations for improvement that were implemented beginning in 2002. These recommendations included improving communication of the survey process and results, improving the survey process by automating and varying the frequency/timing, and updating the survey definitions and purpose.

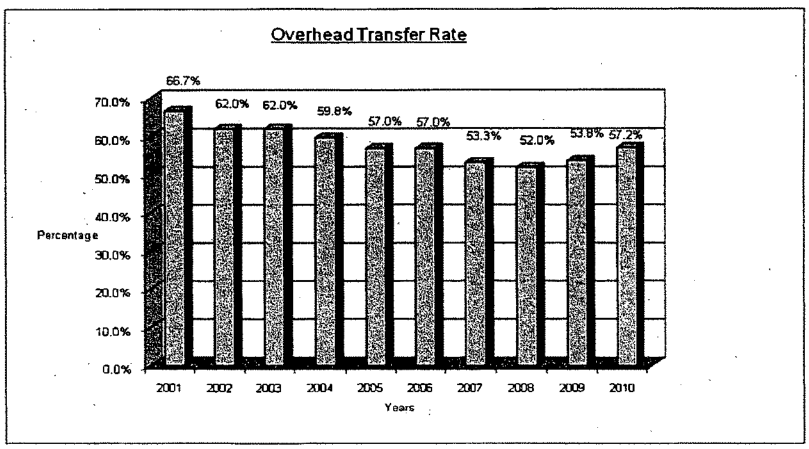
In 2002, the OTR was set at 62 percent. E&I implemented Deloitte and Touche's recommendations to automate the survey collection process, enhance guidance and training for examiners, collect surveys on an ongoing basis (beginning in June 2002), and establish a help-line and public folders to better communicate issues. Automated survey collection began in June 2002. At year end, examiners had uploaded 167 surveys.

In November 2003, the NCUA Board used a refined method to calculate and assess the OTR. The new method is more comprehensive, with the formula expanded to take additional factors into account. The calculation methodology approved in 2003 has been applied by NCUA to calculate the OTR annually. The key components of the OTR calculation methodology include:

- The results of an annual Examination Time Survey performed by a randomly selected group of principal examiners;
- NCUA's resource workload budget;
- NCUA's financial budget;
- The distribution of insured assets between federally chartered and state chartered federally insured credit unions; and
- An estimate of the value of "insurance-related" work conducted by state regulators.

In the following years, the OTR amount declined gradually, with a value of 53.8 percent in 2009. In 2010, the OTR increased slightly to 57.2 percent. Figure 5 below shows the OTRs during the 2001 - 2010 period.

Figure 5: OTR rates in the 2000s



2.3.4. Ramifications of the OTR

A higher OTR results in a lower operating fee charged to FCUs. Since the OTR funds a portion of NCUA's budget, when the OTR increases the amount of NCUA's budget funded by operating fees paid by FCUs falls. This might have significant effects on the interactions between the related parties. A lower federal operating fee makes the federal charter more attractive to the credit unions and extends a competitive edge to the federal charter over the state charter. It might also make state chartered credit unions switch to the federal charter.

The OTR is an expense that reduces NCUSIF's income, which in turn reduces the amount of funds available for dividends (or to offset premiums). NCUSIF pays all the federally insured credit unions dividends whenever its collective earnings, consisting of the one percent deposits received from the credit unions and the interest earnings from the assets net of costs, exceeds the deposits received by more than 1.3 percent.[5] The dividend payment is allocated by FCUs and FICUs' insured share of assets. A higher OTR increases NCUSIF costs, which in turn potentially reduces the amount of dividends paid out. This reduction in pay out affects both FCUs and FISCUs uniformly.

Some state regulators set their operating fees in line with NCUA's operating fee structure, to stay competitive in the market. Thus, a higher OTR, resulting in a lower federal operating fee, may force the SSAs to lower the operating fees they collect from the FISCUs. Since the state regulators, unlike NCUA, do not receive any additional funds from NCUSIF for the "insurance-related" activities, this in turn may cause a potential decrease in funding for the state regulator's examination and safety-and-soundness program.

[5] The NCUA Board sets up the normal NCUSIF operating level at 1.3 percent and the operating level is typically reviewed by the NCUA Board at the end of each calendar year.

3. Overview of Existing OTR Computation and Administration

This section presents an overview of the current OTR Methodology, with a discussion of the underlying steps, assumptions and data sources. For expositional purposes, the key steps associated with the OTR Methodology are depicted in Figure 6 and listed below.

1) Classification of NCUA's operational activities into those deemed to be in keeping with its role as a regulator (i.e. "regulatory" activities) and other activities deemed to be associated with its role as an insurer (i.e. "insurance-related" activities).

2) Allocation of NCUA's total budgeted time/hours for the year between "insurance-related" and "regulatory" activities based on survey of hours spent by NCUA examiners over the preceding twelve-month cycle and other allocation factors.

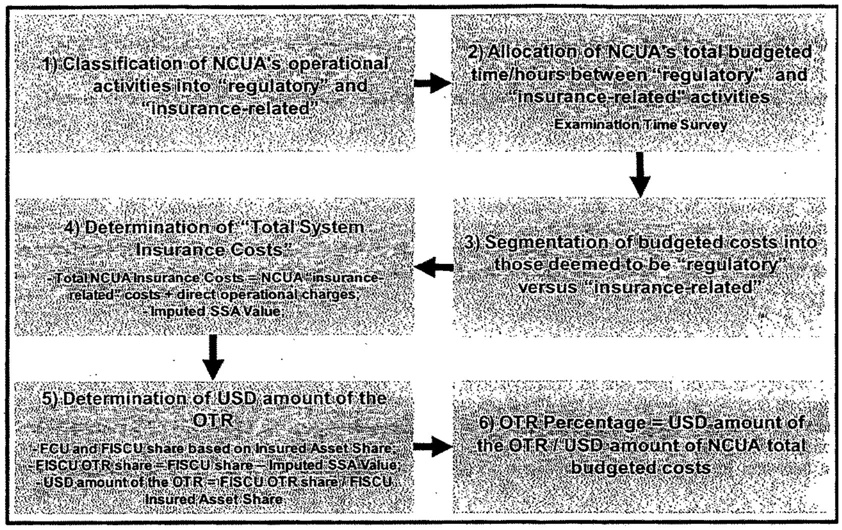
3) Segmentation of budgeted costs (under different categories) based on the allocation percentage determined for workload hours for the associated categories of expenses as determined in the previous step and other allocation percentages for cost categories that are not covered by the survey into those deemed to be "insurance-related" versus "regulatory".

4) Determination of total estimated "system wide" costs of "insurance-related" activities (referred to herein as the "Total System Insurance Costs") as:
   a. The sum of all costs classified as "insurance-related" in the steps above plus other direct operational charges (together referred to herein as the "Total NCUA Insurance Costs"); plus
   b. An estimate of the costs associated with the "insurance-related" work performed by the SSAs for the benefit of FISCUs (the "Imputed SSA Value").

5) Determination of the U.S. Dollar ("USD") amount of the OTR through the following steps:
   a. Allocation of the Total System Insurance Costs between FCUs and FISCUs based on the relative share of insured assets (referred to herein as the "Insured Asset Share") for each category of credit unions;
   b. Subtraction of the Imputed SSA Value from the amount of the Total System Insurance Costs allocated to FISCUs to determine the USD amount of the OTR that should be "borne" by FISCUs (referred to herein as the "FISCU Share of OTR") using their Insured Asset Share as an allocation basis; and
   c. Finally, division of FISCU Share of OTR by their Insured Asset Share to determine the total USD amount of the OTR that should collectively be "borne" by FCUs and FISCUs.

6) Division of the USD amount of the OTR by the USD amount of the total budgeted costs for NCUA to determine the applicable OTR (as a percentage)

Figure 6: Diagrammatic illustration of the OTR Methodology



The subsequent sections present the steps, inputs and other details associated with the computation of the OTR. These sections draw on the description of the OTR Methodology as contained in the NCUA Board Action Memorandum dated November 19, 2009.

3.1.1. NCUA's Definition of Insurance and Regulatory Activities

The starting point in the calculation of the OTR is the classification of NCUA's activities into two categories - the "insurance-related" activities are those that are in keeping with its role as an insurer of all federally insured credits units (i.e. FCUs and FISCUs) while the "regulatory" activities are those that are deemed by NCUA to be "driven by" its role as a regulator and charterer of credit unions (i.e. FCUs). The "insurance-related" functions mostly involve activities related to analyzing safety-and-soundness of the insured assets of all federally insured credit unions. All other "insurance-related" activities involve evaluating exposure to losses among these credit unions. The "insurance-related" functions are thus viewed by NCUA as including the following:

- Evaluating financial trends and Call Report data[6];
- Determining the credit union's solvency position;
- Evaluating risks and potential costs, the credit union presents to NCUSIF (as and when applicable);
- Assessing management's efforts to protect earnings and net worth by identifying, evaluating, controlling, and monitoring internal and external risks; and
- Assessing management's abilities to develop strong policies and a reliable internal control structure.

Non-insurance or regulatory activities, specifically as they relate to examination or supervision contacts with FCUs, focus on issues of compliance with the laws and regulations that NCUA enforces.

[6] Call report refers to the reports that are submitted by federal insured credit unions to NCUA and contain data on a credit union's financial condition and other operating statistics.

Time incurred by NCUA on regulatory activities is associated with its efforts to review, report, or document areas that include, but are not limited to, the following:

- Compliance with consumer protection laws, NCUA rules and regulations, the Federal Credit Union Act and bylaws;
- Review of previously cited regulatory violations, areas of concern, and corrective actions taken; and
- Call report accuracy and timeliness.

Based on NCUA's definition/characterization of its activities (as "insurance-related" versus "regulatory"), the subsequent steps in NCUA's OTR calculation are aimed at estimating and determining the costs that it incurs specifically on "insurance-related" functions after making adjustments that affect the allocation of the "burden" of these costs among FCUs and FISCUs as is described below. Appendix A contains the actual figures associated with each of these steps for the 2010 OTR calculation.

3.1.2. Step 1 - Workload Program

The first step in the actual computation of the OTR is the allocation of the total hours budgeted by NCUA (the "Workload Budget Hours" or the "Workload Budget") for its various personnel through which it performs its insurance and regulatory functions into those that relate to its regulatory function and those that relate to its insurance function. This allocation is achieved by using two distinct procedures/mechanisms, each of which applies to one or more NCUA categories of activities or "Programs":

- The Examination Time Survey is the source of the allocation basis for "Core Programs" that cover "contacts" with credit unions related to their examination ("Federal Examination" code 10) or supervision ("Federal Supervision" code 22) which together account for the majority of the Workload Budget Hours;
- The allocation basis for NCUA's Workload Budget Hours associated with "Other Core Programs" and "Special Programs" is based on as assessment of the specific characteristics of these Programs and their overall purpose.

3.1.2.1. Examination Time Survey

The key personnel with respect to NCUA's Federal Examination and Federal Supervision programs are the field examiners who conduct these examinations and reviews of the different credit unions. The primary responsibility for a particular credit union with respect to examination is assigned to one examiner known as the "Principal Examiner" ("PE"). All field examiners are organized into 63 groups referred to as "Supervisory Examiner" ("SE") groups that are spread across NCUA's five regions. The Examination Time Survey (referred to herein as "ETS") is a survey that E&I administers to a randomly selected SE group from each region.[7] The survey is completed by all PEs for each selected SE group from each region. The PEs are chosen based on their background and experience in specific fields. The PEs may be supported by other field examiners and subject matter experts in order to provide an accurate determination of the proportion of time devoted to "insurance-related" and regulatory activities.

As mentioned above, the ETS is used to determine the percentage of Workload Budget Hours related to regulatory and "insurance-related" tasks for the following two programs:

- Federal Examination (Code 10); and
- Federal Supervision (Code 22).

Since 2007, the ETS has been implemented through an online form on the AIRES server. Examiners receive training and detailed instructions on how to fill out the ETS. There are twelve categories of activities on the survey form, modelled on the risk based examination program. For each of these

[7] In June 2002, NCUA used a lottery system to select one SE from each region to participate in the survey. The survey responsibilities rotate on an annual basis to the next SE in alphabetical order.

categories, the examiner has to input the hours spent on regulatory and "insurance-related" activities. A full year's worth of survey results are used to calculate the percentage of hours devoted to regulatory (and insurance-related) activities for the Federal Examination and Federal Supervision Programs.

3.1.2.2. Percentage of Regulatory Time Spent on Other Core Programs and Special Programs

The time spent on regulatory activities for Other Core and Special Programs is determined based on a review of the characteristics of the Programs (i.e. the underlying purpose behind the Program). The Workload Budget Hours associated with Programs deemed to have primarily a regulatory purpose would all be treated as regulatory. Other Programs, such as the "State Exam and Supervision Program," have all their Workload Budget Hours treated as "insurance-related" based on fact that the NCUA does not have regulatory responsibilities with respect to FISCUs. Other Core and Special Programs that are deemed to have a "mixed role" have their associated Workload Budget Hours classified based on the percentage of regulatory versus "insurance-related" costs utilizing the results from the ETS for the Federal Examination Program. For the Small Credit Unions Program, the percent of time spent on regulatory activities was estimated through informal surveys to the department head.

3.1.2.3. Workload Budget

As described, NCUA's Workload Budget provides the budgeted hours for NCUA's activities associated with its Core and Special Programs. These hours make up the "productive" hours for NCUA's examiners and other specialized staff working on the core and special programs. Once the regulatory percentages are determined for all the Core and Special Programs, they are applied to the budgeted hours for each of these Programs as specified in the Workload Budget to determine the total hours characterised as "regulatory" (or conversely as "insurance-related"). Adding the hours thus classified together, the total hours classified as "regulatory" (or conversely as "insurance-related") are determined. Dividing this amount by the total budgeted hours for all Core and Special Programs is used to determine the weighted average percentage of Workload Budget Hours that can be characterized as "regulatory" (or conversely as "insurance-related"). This weighted percentage of total Program hours that is ascribed to NCUA's regulatory role is then treated as the "regulatory cost driver" (the "Regulatory Cost Driver") - i.e. the percentage of NCUA's total costs that stem from its regulatory role, used in subsequent steps of the OTR calculation.

3.1.3. Step 2 - Application of "Regulatory Cost Drivers" to NCUA Financial Budget

After determining the Regulatory Cost Driver which represents the weighted average percentage of NCUA's budgeted "productive" hours that are ascribed to its regulatory role, this percentage (along with certain other "cost drivers" discussed below) is applied to NCUA's budgeted costs for the relevant year under different categories/cost centers to determine the total amount of NCUA's costs that are classified as "Non-Insurance Costs". For 2009, the costs associated with the Core and Special Programs accounted for 58 percent of NCUA's total budgeted costs and the Regulatory Cost Driver as determined in Step 1 was directly applied to such costs. For the remaining costs, different cost drivers were assigned to determine the amount of Non-Insurance Costs. For instance, the cost center "Asset Management Assistance Center and Assistance Program" was assigned a cost driver of zero percent given that this represents the NCUSIF function that handles liquidation payouts, management of assets acquired from liquidation and recoveries for the NCUSIF and as such none of the associated costs can be classified as Non-Insurance Costs.

3.1.4. Step 3 - Calculation of NCUSIF Costs

The purpose of Step 2 was to determine the portion of NCUA's budgeted costs that is related to its regulatory role. The subtraction of this amount from NCUA's total budget yields the portion of NCUA's budget that is associated with its role of managing the NCUSIF. Under Step 3, the following amounts associated with the operational costs of providing NCUSIF deposit insurance are added to this budget figure in order to arrive at a measure of Total System Insurance Costs:

- Certain direct operational charges to NCUSIF; and
- The Imputed SSA Value that represents an estimate of the costs associated with the "insurance-related" work performed by the SSAs for the benefit of the FISCUs and is thus part of the total "system wide" operational costs of providing NCUSIF deposit insurance.

3.1.4.1. Direct Operational Charges to NCUSIF

Direct operational charges to NCUSIF include costs associated with providing state examiners with equipment and training. These costs are not included in NCUA's total budgeted costs referenced in the previous steps.

3.1.4.2. Imputed SSA Value

The incorporation of the Imputed SSA Value is driven by the need to account for the fact that not all "insurance-related" costs associated with NCUSIF (and thus "borne" by the credit unions) are incurred by NCUA. A portion of the total "system wide" cost of providing the NCUSIF federal share insurance is actually incurred by the SSAs that recover such costs through the operating fee charged to FISCUs. The estimation of the Imputed SSA Value and its incorporation in the OTR calculation is in recognition of the fact that absent these SSAs and the work performed by them, NCUA's "insurance-related" costs would be higher. This estimation involves the following four steps:

Imputed SSA Value Step 1: Gross Workload

The first step in this process is to determine, using an identical criteria as for FCUs, what level of examination time would be required to examine all FISCUs. To do this, first the examination hours NCUA actually expended on FCUs during the prior fiscal year are examined, by asset size and CAMEL rating. Next, this estimate of hours for FCUs by CAMEL rating/asset size is applied to the distribution of FISCUs across CAMEL/asset size category in order to arrive at an estimate of the total hours needed to perform the similar function for the FISCUs as is performed for the FCUs. These two steps together are used to arrive at an estimate of the exam hours needed if NCUA were to conduct all of the state examination work in a manner that is equivalent to what is employed for FCUs.

Imputed SSA Value Step 2: Net Workload

Step 1 calculates the hours needed if NCUA were to conduct examinations in all FISCUs. The same distribution of insurance to non-insurance ratio that is used for FCUs as determined in previous steps is applied to determine the total hours it would take NCUA to supervise FISCUs to meet its role as insurer.[8]

Imputed SSA Value Step 3: Additional Staff Needed

In this step, the additional hours computed in step 2 above is converted to the number of additional examiners required to accomplish these additional tasks. Using NCUA's workload budget and taking into consideration adjustments for various benefits, training, and administrative time, a productivity ratio and the resulting productive hours are calculated per full-time equivalent ("FTE") examiner. Using this productive hours per examiner and the net additional hours, the number of FTE examiners needed to accomplish the additional tasks are then computed.

In order to perform these incremental activities, additional staff and other resources (overhead) to manage and administer these additional examiners would be required (e.g. additional Supervisory Examiners, Regional Office Analysts, Human Resource Personnel, facilities, etc.). To estimate the incremental resources, NCUA's staffing patterns and organizational structure were reviewed and ratios of examiners to other positions based on ratios that are actually employed in running the agency were developed. The estimate of additional FTE examiners and staff are computed on this basis.

[8] In addition, adjustments for the deferred examination program, an adjustment for needed additional supervision and an adjustment for unnecessary state review are also made to calculate additional hours that NCUA would have spent if it were to examine and supervise, from an insurance perspective only, all FISCUs using the same insurance-based criteria applied to FCUs.

Imputed SSA Value Step 4: Imputed Cost

Finally, the average cost per FTE is used to compute the total cost of these incremental resources. The average cost used is based on the actual budget for regional offices and field staff and includes all costs, such as travel, training, facilities, consumables (e.g., supplies), in addition to salary and benefits, necessary to run a field program.

In addition, other adjustments are made to account for the potential impact of the additional workforce. With this additional staffing, there would be an impact on the workload of the Office of Human Resources ("OHR"). Thus, a proportionate increase in OHR's budget is projected. In addition to increases in certain costs, there would be some areas of savings to NCUA if it conducted all of the "insurance-related" FISCU work. There would be no need to pay for the training of state examiners, or providing SSAs with computers and other equipment. The final Imputed SSA Value is calculated by making adjustments for these costs and savings.

3.1.5. Step 4 - Allocation of NCUSIF Costs

The final step is the calculation of the OTR amount, both as a U.S. dollar ("USD") value and as a percentage of the total NCUA budgeted costs. In Step 3, the total "system wide" costs of providing the NCUSIF federal share insurance is determined that takes into account the "insurance-related" work performed by the SSAs. Once this total cost is calculated, it is allocated between FCUs and FISCUs using their respective Insured Asset Shares as a proportional allocation basis. Finally, since the SSAs actually provide part of the "insurance-related" services to FISCUs associated with NCUSIF, the FISCU share of the total "system wide" NCUSIF insurance cost is adjusted by deducting the Imputed SSA Value to determine the cost of NCUSIF insurance to FISCUs that is incurred specifically by NCUA.

Next, the USD amount of NCUA's costs associated with managing the NCUSIF to be absorbed by FISCUs through the OTR (as calculated previously) is divided by FISCUs' Insured Asset Share (i.e. proportional allocation basis). This yields the total USD amount of NCUA's costs of managing the NCUSIF that is "borne" by <u>all</u> insured credit unions through the OTR. For the 2010 calculations, this USD amount was $115.0 million. Upon determination of the USD amount of the OTR, this value is divided by the total NCUA budget to calculate the OTR as a percentage of the NCUA budget. For the 2010 calculations, this value was calculated as 57.2 percent.

4. Methodology

4.1. Description of Approach

This study and its conclusions are based on facts and data presented to PwC by NCUA, which has verified to PwC the accuracy of these facts presented in this study. In keeping with our regular practice, PwC has not independently audited these representations as part of the preparation of this study, although PwC has determined that the facts as presented appear reasonable. PwC based its understanding of the functions performed, risks assumed, and resources employed by various parties on discussions with NCUA personnel, discussions with key stakeholders (these include industry groups such as CUNA, NAFCU, and NASCUS, and representatives from federally insured credit unions such as the BECU), relevant literature and other information available in the public domain. An overview of the overall approach is presented below followed by a more detailed description of the process undertaken by PwC in its review of the OTR Methodology.

To complete this study PwC undertook the following steps:

1) Conducted interviews with and requested key information from NCUA personnel identified as being relevant in order to develop a comprehensive understanding regarding the NCUA's OTR Methodology, the constituent steps and underlying assumptions;

2) Identified and conducted interviews with "key stakeholders" in the U.S. credit union system that included credit unions and trade associations for federal and state charter credit unions as well as that for the state regulatory authorities;

3) Identified the stakeholders' views on attributes that an appropriate OTR Methodology should possess as well as the concerns and issues with regards to the current OTR Methodology as perceived by these stakeholders;

4) Developed a set of criteria to evaluate the current OTR Methodology based on the concerns and issues identified by the key stakeholders; and

5) Evaluated NCUA's current OTR Methodology against the set of criteria so as to arrive at a conclusion on the soundness and reasonableness of the current OTR Methodology and develop recommendations and suggestions for improvement.

4.2. Methodology

As part of its analysis, PwC conducted interviews with personnel from NCUA and other identified stakeholders in the U.S. credit union system, including, but not limited to:

- Personnel from NCUA whose current or past responsibilities included the implementation of the OTR Methodology and presentation of these calculations to the NCUA Board. Among the personnel interviewed were those that had familiarity with the 2003 special task force that proposed revisions to the existing OTR Methodology at the time.
- A senior PE with experience in field examinations as well as with the ETS. A PE is an experienced examiner who is involved in examination reviews and field examinations for federally insured credit unions. The interviewed PE has responsibility to fill out the time survey on behalf of all the examiners that worked on the credit unions for which the PE was the Examiner in Charge.

- Industry groups such as CUNA, NAFCU, and NASCUS. The description of each of these trade groups are as follows:

    - CUNA: CUNA is a national trade association serving America's credit unions. The not-for-profit trade group is governed by volunteer directors who are elected by their credit union peers. In partnership with state credit union leagues, CUNA provides many services to credit unions, including representation, information, public relations, continuing professional education, and business development. CUNA represents about 97 percent of all credit unions, including both the FCUs and FISCUs, which gives them the unique opportunity to represent both the federal and state credit unions equally.

      The members interviewed include the Senior Vice President and the Chief Economist.

    - NAFCU: NAFCU is a trade association that exclusively represents the interests of federal credit unions before the federal government and the public. NAFCU provides its members with representation, information, education, and assistance to meet the challenges that cooperative financial institutions face. Over the years, NAFCU has been a highly effective force in influencing legislation and regulation affecting federal credit unions.

      The members interviewed include the General Counsel for Regulatory Affairs and the Chief Economist.

    - NASCUS: NASCUS, a professional regulators association, is the primary resource and voice of the 47 state governmental agencies that charter, regulate and examine the nation's state-chartered credit unions. NASCUS is the only organization dedicated to the defense and promotion of the state credit union charter and the autonomy of state credit union regulatory agencies. NASCUS also represents the interests of state agencies before Congress and is the liaison to federal agencies, including the NCUA. NASCUS also has been focused on preserving the dual chartering system and representing the interests of state-chartered credit unions.

      The members interviewed include the President and CEO, the Senior Vice President for Regulatory Affairs and the Vice President for Communications and Public Affairs.

In conjunction with the interviews, PwC obtained and studied the following documents that were made available to it by one or more of the aforementioned parties or located in the public domain to develop a comprehensive understanding of the history, constituent steps, assumptions and data sources associated with the current OTR Methodology:

- Documents received from NCUA and from NCUA website -

    - 2008 and 2009 Board Action Memorandum ("BAM"): Through the BAM, the Office of Examination and Insurance at NCUA presents the following year's recommended OTR to the NCUA Board for approval. The BAM includes a brief summary of the current OTR calculations including the summary results of the time survey. The detailed calculations are also included in the appendix. The BAM is made available to the public and interested parties through the NCUA website.

    - 2003 Task Force Proposal: This is the report submitted by a five member NCUA Task Force that was formed in 2003 to review the OTR Methodology. This is a detailed report on the analyses performed by the 2003 task force, and it includes in depth discussions on the proposed methodology, the then-current OTR Methodology, the Examination Time Survey, history of OTR and its legal and philosophical basis, other alternatives considered, and some potential criticisms and responses. The discussions included in this report are not only aimed at explaining the proposed OTR Methodology, but also at justifying the need to update the existing methodology with the new one.

    - 2007 NCUA Annual Report: The annual report includes financial information pertaining to NCUA and also some relevant industry statistics pertaining to the credit union system as a whole.

- Organizational charts: The organizational charts received from NCUA provide information on the internal NCUA structure and identifies the number of personnel employed at each regional office.
- 2007 revised Federal Credit Union Act: The Federal Credit Union Act provides the historical background for the creation of the NCUA and the NCUSIF and the implementation of the OTR.

- Documents received from other sources -
  - GAO 2003 report on credit unions: The GAO report provides an overview of the state of the credit union system around 2003 and a third party assessment of the then-current NCUA OTR calculations.
  - 2001 paper on OTR titled "Caught in a Regulatory Vise: The Peculiar Problem Faced by Federally Insured State-Chartered Credit Unions" by Lawrence White, received from BECU: This paper was commissioned by BECU to serve as an evaluation of the OTR Methodology from an FISCU perspective. The paper presents the OTR concerns and issues and some potential solutions for these issues, as identified by the author.
  - 2001 white paper received from NASCUS titled "Restructuring the NCUA": This was a white paper commissioned by the NASCUS to evaluate NCUA's dual role as an insurer and a regulator.
  - Data on the credit union system from the 2010 Statistical Abstract, U.S. Census Bureau: This is a time series data that look at FCUs and FISCUs over 40 year period. The variables reported include, but are not limited to, the number of FCUs and FISCUs, FCUs and FISCUs by membership, and FCUs and FISCUs by assets under management.
  - Data and information on the operations of the Federal Deposit Insurance Corporation ("FDIC") from the FDIC website and the FDIC 2009 Annual Report: The FDIC annual report provides information and data on the operations and workings of the FDIC and some relevant financials.
  - Data and information on the operations of the Office of Comptroller of Currency ("OCC") from the OCC website and the OCC 2009 Annual Report: The OCC annual report provides information and data on the operations and workings of the OCC and some relevant financials.

Based on the interviews and the material studied, PwC identified four criteria for purposes of evaluating the current OTR Methodology and recommending possible revisions/amendments/modifications for NCUA's consideration. The criteria (each of which is subsequently referred to as an "Evaluation Criterion" and collectively referred to as the "Evaluation Criteria") are listed below.

1. <u>Transparency</u>

The OTR Methodology and its underlying steps, assumptions and data sources should be communicated clearly and regularly to stakeholders in the credit union system so as to develop broad and consistent understanding among these stakeholders. Of fundamental importance to the computation of the OTR is the distinction between activities and associated expenses deemed to be associated with NCUA's role in managing the NCUSIF (i.e. expenses that can be characterized as being "insurance-related" and thus included in the OTR) and other activities classified as those in keeping with the NCUA's role as regulator (and thus excluded from the OTR). Given this, the OTR Methodology should be based on a classification that represents a consensus (among the NCUA and other stakeholders in the credit union system) with regards to such activities.

2. <u>Accuracy</u>

Subject to the classification of activities as "insurance-related" and other activities, the calculation of the OTR should be predicated on a methodology that is able to measure and track the expenses associated with such activities accurately and consistently across different regions and over time.

3. Equity

The calculation and administration of the OTR should not, ex-ante, favour or disadvantage one type of credit unions (i.e. federal versus state chartered) over another.

4. Reasonable Administrative Burden

The OTR Methodology needs to be such as to balance the objectives of criterion 1 through 3 while keeping costs of implementation manageable.

5. Economic Analysis

This section presents a summary of PwC's review of NCUA's existing OTR Methodology based on the Evaluation Criteria identified above. The objective of the review was to arrive at a review of the OTR Methodology with respect to the specific Evaluation Criterion and to make recommendations if warranted by the review. The concerns and issues associated with the OTR Methodology that were considered under each specific Evaluation Criterion were validated by the key stakeholders interviewed by PwC as part of the review process.

5.1. Transparency

Two specific attributes of the OTR Methodology and its implementation were considered under this section. First, given how important NCUA's classification of its activities as "insurance-related" and "regulatory" is to the OTR calculation, PwC sought an understanding of whether there was agreement among the stakeholders in the credit union system with regards to the reliability of this classification. The second question considered here was whether there is reasonable understanding among the stakeholders of the OTR Methodology, steps and inputs that go into the calculation and the underlying assumptions.

5.1.1. Definition of Insurance and Regulatory Activities

A consistent concern that was commonly expressed by the key stakeholders regarding the OTR Methodology is with respect to how NCUA classified its activities (and thereby costs) as "insurance-related" and "regulatory". From the perspective of these industry groups and credit unions, the lack of an industry-mandated definition of "insurance-related" and "regulatory" activities made the classification adopted by NCUA as potentially biased. A prevailing view among some sections of the industry is that certain costs that get classified by NCUA as being consistent with its role as insurer (e.g. those related to the safety-and-soundness of credit unions) would have to be undertaken by NCUA even if its role were solely that of a regulator. Additionally, the costs that should be included in the OTR should be limited to those associated with additional reviews and site visits by examiners of credit unions whose original safety-and-soundness reviews revealed specific concerns from an insurer's perspective.

5.1.2. Assumptions and Calculation Steps

The calculation of the OTR involves multiple steps, data sources and underlying assumptions. Our discussions with the stakeholders revealed a prevalent view that there was not a satisfactory level of understanding within the industry with regards to the various components of the OTR calculation. While NCUA periodically issues BAMs, Board Action Bulletins and other publications about the OTR calculation, these documents were not viewed as being sufficient in explaining to the industry the methodology in adequate detail. The key stakeholders expressed that the method needs more transparency, the assumptions need to be made public and the calculation steps need to be explained in more detail. Additional concerns were expressed by these stakeholders regarding related subjects such as the NCUA budget, the target equity ratio, etc. which are perceived to be either affected by or have influence on the OTR amount. In addition, one key stakeholder commented that the OTR decisions are made by NCUA without any formal notice or comment as required by the Administrative Procedure Act.

Conclusion

Based on PwC's review, the OTR Methodology was considered lacking in terms of the extent to which the classification of NCUA's activities between insurance and regulatory (upon which the methodology is fundamentally dependent) represents a consensual view on such a characterization in the industry. Further, there was found to be dissatisfaction within the industry with respect to NCUA's efforts to communicate and explain the OTR Methodology in adequate detail.

Recommendations

A review and assessment of the reasonableness of NCUA's definition and characterization of its activities among those related to insurance and those consistent with its role as a regulator was outside the scope of this study. However, it is PwC's view that NCUA should consider providing more visibility on how it characterizes its activities to the different industry groups and credit unions and possibly solicit their feedback with regards to the reasonableness and accuracy of the classification. This would be a step towards developing a classification basis that incorporates the industry's views on the matter and would serve to dispel potential confusion and concerns within the industry.

NCUA should also consider steps aimed at making the methodology itself more transparent, along with all of the assumptions and steps that are utilized. Possible ways of achieving this include more frequent interactions with the stakeholders through different channels (e.g. meeting, publications, etc.). NCUA should also check if the OTR decisions are subject to the Administrative Procedure Act and if formal notice or comments are required on its OTR calculation process and results.

5.2. Accuracy

In this section, the following elements of the OTR methodology are analyzed from the perspective of their ability to accurately and consistently "measure" the expenses associated with the management of NCUSIF incurred on behalf of all federally-insured credit unions:

1) Education and training of examiners with respect to the distinction between "insurance-related" activities and "regulatory" activities;

2) Reliability and accuracy of the results attained from the ETS;

3) Reasonableness of other allocation factors used to determine Regulatory Cost Drivers;

4) Validity of Imputed SSA Value calculation; and

5) Validity of Insured Asset Shares.

This section concludes with an analysis of the sensitivity of the results of the OTR calculation on the variance of the ETS results, other allocation factors and Imputed SSA Value.

5.2.1. Implementation of ETS - Education and Training of Examiners

As discussed in the section above, the definition of what constitutes an "insurance-related" activity versus a "regulatory" activity is an important input in the overall OTR Methodology. Of significant importance is also how consistently this classification is applied throughout the implementation of ETS and other steps of the OTR calculation.

NCUA administers the ETS to a randomly selected SE group from each region.[9] The survey is completed by all PEs for each selected SE group from each region. The PEs are chosen based on their background and experience in specific fields. The PEs may be supported by other field examiners and subject matter experts in order to provide an accurate determination of the proportion of time devoted to insurance and non-insurance related activities. The survey responsibilities rotate

[9] NCUA's operations are divided into five regions, each containing between 9 and 18 SE groups.

on an annual basis to the next SE group in alphabetical order. Rotational sample selection guarantees that all PEs are eventually selected for participation in the survey.

For the implementation of ETS, NCUA holds a formal training session for survey participants and a subsequent teleconference for the survey participants, their supervisors, and a regional office analyst from each region. The formal training session provides detailed steps on how to fill out the ETS online. Online help that can be contacted via a specific and dedicated email address for survey participants to request help with the survey is maintained. The regional office analyst and the Office of the Chief Information Office customer services are also made available as resources to provide support on the survey. In addition, NCUA sets up a public folder to store information such as Frequently Asked Questions, summary reports and training information.

The ETS form provides twelve time categories, including planning/scope development, call report review, supervisory committee review, financial analysis, loan analysis, investment analysis, liquidity analysis, asset liability management, compliance, information system technology, management and examination report/JC/follow-up. For each time category, the time survey instruction provides detailed examples on activities covered and whether such activities should be characterized as "insurance-related" or "noninsurance-related". Based on our interview with an NCUA examiner, the ETS form and instruction is clear and easy to understand. By referencing the instructions, the examiner had no difficulties in allocating time between "insurance-related" activities and "noninsurance-related" ones.

Based on the forgoing, NCUA personnel in charge of examinations and reviews have a clear understanding of the classification between "insurance related" and "non-insurance related" activities. Furthermore, this classification is communicated to the examiners through what can be considered well-structured tools and training modules.

Conclusion

Based on PwC's review, the current definition of insurance and regulatory activities is appropriately communicated to the examiners through well-structured tools and training modules. The process provides enough resources available for examiners to learn how to fill out the Examination Time Survey. Given the scope of this study, it was not possible for PwC to ascertain whether all examiners have a uniformly high level of understanding of the definition of "insurance-related" and regulatory activities.

5.2.2. ETS Reliability

The results of the ETS are an important input in the OTR calculation through the determination of the Regulatory Cost Drivers (used to determine the portion of costs associated with regulatory activities as opposed to insurance). The ETS is completed by all PEs for each selected SE group from each region. The survey responsibilities rotate on an annual basis to the next SE group in alphabetical order. The reliability of the results attained from the ETS is particularly dependent on the following factors:

1) Adequacy of the sample size and representation relative to the population; and
2) Achieved margin of error for the estimated percentage of "insurance-related" activities per the survey results.

5.2.2.1. Sample Size and Representation Relative to Population

The results of the ETS covering the period from June 1, 2008 through May 31, 2009 (the "2008-09 ETS") were reviewed by PwC with respect to the representativeness and sufficiency of the sample relative to the underlying population. Table 1 presents the 2008-09 ETS' sample attributes in terms of its coverage of regions, SE groups, PEs, work hours under the Federal Supervision (code 22) program, work hours under the Federal Examination (code 10) program and the number of FCUs covered relative to the population.

Table 1: 2008-09 ETS sample attributes

	Number of Regions	Number of SE Groups	Number of PEs	Estimated Supervisory Examiner Groups work hours under Federal Supervision (code 22)	Estimated Supervisory Examiner Groups work hrs under Federal Examination (code 10)	Number of FCUs contacted under code 22 or code 10[10]
Selected in survey	5	5	31	4,859	17,064	279
Total in population	5	63	289	105,850	369,750	6,989
Percent to total	100%	8%	11%	5%	5%	4%

Source: PwC computation based on data provided by NCUA

An annual rotation of survey participants by SE group obtains representative coverage of the population across all regions and SEs, while minimizing the burden on field staff. Due to the rotational nature of the sample selection, slight departures from the population distribution can be reasonably expected in any given sample. Given this and based on the results shown in Table 1, the 2008-09 ETS sample can be considered to obtain adequate size and representation across regions, SE Groups, PEs, work hours and FCUs.

A credit union's insured asset size and its CAMEL rating have a direct correlation with the intensity of "insurance-related" review and activity required for that credit union. The percent of "insurance-related" activities for FCUs under the ETS by asset size and CAMEL rating can be seen in Table 2 below. The 2008-09 ETS results show that the bigger the credit union, the higher percentage of total examination hours that is insurance-related and the riskier the credit union according to the CAMEL rating, the higher the percentage of total examination hours that is insurance-related. Thus, it is crucial that the distribution of the ETS sample by asset size and CAMEL rating is consistent with the population under the ETS.

Table 2: Percent of insurance-related activities for surveyed FCUs by asset size and CAMEL rating

Percent of insurance-related activities for FCUs in each category (2008-09 survey)	Assets < $10M	$10 - $100M	$100 - $250M	$250 - $500M	>$500M
CAMEL 1	51.14%	59.47%	56.11%	63.18%	57.96%
CAMEL 2	59.09%	63.49%	57.91%	64.34%	66.77%
CAMEL 3	59.51%	62.45%	60.71%	63.74%	
CAMEL 4	67.53%	70.77%	78.67%		
CAMEL 5	67.44%				

Source: PwC computation based on data provided by NCUA

PwC compared the distribution of credit unions by: a) CAMEL rating; and b) asset size in the 2008-09 ETS sample with that in the overall population. Table 3 presents this comparison for CAMEL ratings while Table 4 shows the same comparison for asset sizes.

[10] The number of FCUs contacted under code 22 or code 10 and selected in the ETS sample includes duplicates.

Table 3: Distribution FCUs by CAMEL rating

Number of FCUs as of May 31, 2009	CAMEL 1	CAMEL 2	CAMEL 3	CAMEL 4	CAMEL 5	Total
Selected in survey (no duplicates)	39	90	48	11	1	189
Total FCUs	825	2,780	993	172	12	4,782
% Selected in survey (no duplicates)/Total	5%	3%	5%	6%	8%	4%
Sample distribution	20.6%	47.6%	25.4%	5.8%	0.5%	100.0%
Population distribution	17.3%	58.1%	20.8%	3.6%	0.3%	100.0%

Source: PwC computation based on data provided by NCUA

Table 4: Distribution of FCUs by asset size

Number of FCUs as of May 31, 2009	Assets < $10M	$10M - $100M	$100M - $250M	$250M - $500M	> $500M	Total
Selected in survey (no duplicates)	52	76	32	16	13	189
Total FCUs	2,124	1,970	375	160	153	4,782
% Selected in survey (no duplicates)/Total	2%	4%	9%	10%	8%	4%
Sample distribution	27.5%	40.2%	16.9%	8.5%	6.9%	100.0%
Population distribution	44.4%	41.2%	7.8%	3.3%	3.2%	100.0%

Source: PwC computation based on data provided by NCUA

Based on this comparison, it can be seen that while the distribution of credit unions by CAMEL rating in the sample is not significantly dissimilar to that in the population, this does not hold true to the same extent for the distribution of credit unions by asset size. Credit unions with less than $10 million in assets were under-represented in the sample as compared to the population while those with greater than $100 million in assets were slightly over-represented.

5.2.2.2. Achieved Margin of Error

NCUA determines the number of credit unions selected tin the survey based on a target margin of error of three percent at the 90, 95 and 99 percent confidence levels for the non-insurance workload percentage as estimated from the survey results.

PwC validated the formula used to calculate the required sample size to achieve the desired margin of error and found this to be accurately applied. Next, PwC reviewed a summary of the 2008-2009 ETS results captured separately for the Federal Examination (Code 10) and Federal Supervision (Code 22) Programs, including the means and standard deviations for the estimated non-insurance percentage determined for each Program through the survey. Since the survey results for the Federal Examination (Code 10) and Federal Supervision (Code 22) Programs are separately applied to relevant total workload hours associated with each Program, the sample size for the Federal Examination (Code 10) and Federal Supervision (Code 22) Programs should be evaluated separately so as to determine whether the respective sample sizes achieve the target margin of error.

Based on the results of 2008-09 ETS, PwC estimated that at the 95 percent confidence level, the achieved margin of error was approximately two percent for the Federal Examination (Code 10) Program and five percent for the Federal Supervision (Code 22) Program. The Federal Supervision (Code 22) Program had range of responses for the percent of non-insurance hours from 0 to 100 percent with a much larger standard deviation than that for Federal Examination (Code 10) Program.

Given this fact, in order to achieve the same three percent precision goal for the Federal Supervision (Code 22) Program, a sample size of 454 FCUs was needed as compared to only 56 for the Federal Examination (Code 10) Program as shown in Table 5.[11] While the actual sample size in the 2008-09 ETS for Federal Examination (Code 10) Program was comfortably above the required threshold, the sample size for the Federal Supervision (Code 22) Program of 143 credit unions was below the required threshold necessary for the target margin of error of three percent.

Table 5: 2008-09 survey sample size statistics

2008 - 2009 survey result	Federal Supervision (Code 22)	Federal Examination (Code 10)
Number of FCUs selected in the survey	143	136
Sample size at 95% confidence interval and 3% margin of error	454	56

Source: Data provided by NCUA

Conclusion

Based on PwC's review, the statistical methodology used by NCUA to estimate the non-insurance percentage of workload hours for each program in order to determine the OTR can be considered reasonable. While the sampling methodology obtains representation across regions, SE Groups, PEs, work hours and FCUs it can be improved with respect to the representativeness of the distribution of credit unions by asset size in the sample relative to the population.

Recommendations

An annual rotation for ETS survey participant selection obtains representative coverage of the population across all regions, SE Groups, PEs, work hours and FCUs, while minimizing the burden of field staff. Due to the rotational nature of the sample selection, slight departures from the population distribution are to be expected in any given sample. However, in order to obtain a more representative sample some consideration of sample allocation by asset size and CAMEL rating should be considered as there appears to be some correlation between these characteristics and the percent of "insurance-related" work hours.

Additionally, it is recommended that NCUA use sample sizes that are consistent with the calculated sample sizes for both the Federal Examination (Code 10) and Federal Supervision (Code 22) Programs, and specifically, that NCUA consider increasing the sample sizes for the Federal Supervision (Code 22) Program. With respect to the current sample selection methodology, that is, one SE Group is selected from each region, NCUA should consider selecting more than one SE Group from each region for the yearly ETS.

5.2.3. Other Allocation Factors

In addition to the Core and Special programs, there are Other NCUA Cost Centers for which the insurance/regulatory related percentages, the Other Allocation Factors, are not based on the ETS. These Other Allocation Factors are generally based on an assessment by department heads and the objectives and functions associated with these cost centers. The Other NCUA Cost Centers include the Division of Insurance and NCUA's central offices. Table 6 below provides the 2010 NCUA budget and the estimated "insurance-related" portion of these costs. The total cost for other NCUA cost areas was $85.1 million, which amounted to 42 percent of the total 2010 NCUA budget of $200.9 million. The Other Allocation Factors applied to the 42 percent of the NCUA budget thus have a material impact on how much of NCUA's total budgeted costs are deemed to be insurance-related.

As shown in Table 6, the percent of the overall budget that is made up examiner costs and which is deemed to be "insurance-related" based on the results of ETS was 68.9 percent. The equivalent figure of the other NCUA cost areas based on the Other Allocation Factors was 69.3 percent.

[11] At 95 percent confidence interval.

Table 6: 2010 NCUA budget and insurance-related cost

Based on 2010 OTR calculation (in million USD)	Total 2010 budget	Regulatory related cost	% regulatory related cost / Total 2010 budget	Insurance related cost	% "insurance-related" cost / Total 2010 budget
Examiner costs (regional offices and field)	115.8	36.0	31.1%	79.7	68.9%
Other NCUA Cost Centers (Divisions of Insurance and central offices)	85.1	26.1	30.7%	59.0	69.3%
Total	200.9	62.2	69.0%	138.7	69.0%

Source: PwC computation based on data from 2010 OTR BAM

The following provides a brief overview of the Other NCUA Cost Centers and how the Regulatory Cost Drivers (or conversely the percentage of "insurance-related" costs) is in the 2010 OTR calculation for these cost areas:

- Divisions of Insurance ("DOI"): Each of NCUA's five regions has a regional DOI devoted to overseeing charters and fields of membership. Some NCUSIF "insurance-related" tasks (e.g., insurance coverage questions) are performed by DOI. In the 2010 OTR calculation, DOI's regulatory related percentage was estimated to be 71 percent.
- Asset Management and Assistance Center Costs ("AMAC"): AMAC conducts credit union liquidations and performs management and asset recovery. By definition, all of the AMAC costs were determined to be non-regulatory in nature. As a result, AMAC's regulatory related percentage was estimated to be zero percent in the 2010 OTR calculation.
- Office of Small Credit Union Initiatives ("OSCUI"): OSCUI's primary roles are described as assisting NCUA's risk mitigation program and foster credit union development, particularly the expansion of services provided by small credit unions to all eligible consumers. In the 2010 OTR calculation, OSCUI's regulatory related percentage was estimated to be 90 percent.
- Office of Corporate Credit Unions Costs ("OCCU"): OCCU supervises all corporate credit unions, including non-federally insured state-chartered corporate credit unions due to the systemic risk these institutions pose. Corporate credit unions provide a variety of investment services and payment systems for other credit unions. In the 2010 OTR calculation, OCCU's regulatory related percentage was estimated to be 20 percent.
- For the Office of Chief Financial Officer, the Office of Chief Information Officer and the Office of Human Resources, the regulatory related percentages for these three cost centers were all estimated to be 20 percent.
- For all other costs, which include NCUA board, the Office of Inspector General, etc., the regulatory related percentage calculated for total Core and Special Programs by using the ETS result was applied to such cost areas.

Conclusion

Based on PwC's review, the Other Allocation Factors used to determine the insurance/regulatory percentage of costs for Other NCUA Cost Centers were not found to be based on methods that can be considered as objective and verifiable as the ETS results used to determine the equivalent split for examiner costs. Given that these costs for Other NCUA Cost Centers constitute a significant portion of NCUA's overall budget, the final OTR as determined based on these Other Allocation Factors as an input can potentially be "distorted".[12]

[12] A similar issue was identified for the percent of non-insurance hours estimated for the Small Credit Unions Special Programs. Given the limited number of hours accounted for by this program, the potential distortion resulting from an unreasonable allocation to insurance vs. non-insurance related activities can be considered to be small.

Recommendations

PwC recognizes that implementing a survey of the scope and magnitude of the ETS may neither be feasible nor necessary, especially when the cost centers in question are associated with divisions or departments whose scope and activities are clearly laid out such that it can reasonably be ascertained as either 100 percent regulatory in nature or 100 percent insurance-related. For other NCUA cost areas, NCUA may be better served by having a process that is more objective, formal and verifiable for purposes of determining the percentage of "insurance-related" and regulatory costs. In the absence of such a formal and documented process it is difficult to verify whether the process adopted:

a) Yields results that are consistent across time in terms of their characterization and classification of the department/division activities are "insurance-related" versus regulatory; and/or

b) Robust enough to account for how a department's scope and nature of activities may change over time (e.g. due to change in the economic or regulatory environment).

Based on this, it is our recommendation that NCUA consider adopting a more formal and documented process for determining the Other Allocation Factors that are based on standard and consistent criteria.

5.2.4. Imputed SSA Value Calculation

As discussed above, in Step 3 of the OTR calculation, the estimated "insurance-related" costs in the NCUA budget plus an estimate of costs associated with the "insurance-related" activities conducted by the SSAs (i.e. the Imputed SSA Value) is allocated among FCUs and FISCUs based on their Insured Asset Share. One key assumption for the calculation is that the Imputed SSA Value provides a best estimate of the insurance costs incurred by SSAs and borne by FISCUs through operating fees.

Given the lack of accurate data on "insurance-related" costs incurred by SSAs and borne by FISCUs through operating fees as well as issues of comparability between NCUA costs and SSA costs, NCUA is not able to rely on actual costs incurred by SSAs on "insurance-related" activities. As a result, NCUA estimates this portion of the total "system wide" costs of "insurance-related" activities associated with NCUSIF (i.e. the Total System Insurance Costs) under the Imputed SSA Value calculation. NCUA calculates the Imputed SSA Value as the "incremental" "insurance-related" costs that NCUA would have to incur if the SSAs did not perform any "insurance-related" activities with respect to FISCUs whose assets are insured by NCUSIF. A description of this calculation is contained in section 3.1.4.2.

The step in determining the overall share of the Total System Insurance Costs that is "borne" by the FISCUs is especially important given the associated implications of equity between FCUs and FISCUs (that is addressed in detail under section 5.3). Given this, the Imputed SSA Value should ideally reflect a best estimate of the "fully burdened" costs incurred by the SSAs on "insurance-related" activities that are borne by the FISCUs via the operating fees paid by them. However, the step as implemented in the current OTR calculation excludes an estimate of the "fixed/overhead costs" (i.e. those costs that are unrelated to the number of examination hours) that SSAs incur in their performance of "insurance-related" activities. Other things equal, this implies that the Imputed SSA Value is potentially underestimated under the current method relative to the actual "insurance-related" costs incurred by the SSAs and borne by the FISCUs through the operating fees paid by them through the operating fee.[13]

[13] The fixed/overhead costs associated with NCUA's provision of "insurance-related" services to FCUs could be defined as the overhead costs that NCUA incurs and that are not dependent on the number of examination hours. Of the 2010 NCUA budget of $200.9 million, $ 138.7 million was estimated to be "insurance-related" costs. Out of the $138.7 million "insurance-related" costs, $79.7 million (calculated as the insured-related portion of regional cost and field costs, e.g. $115.8 million - $36.0 million) was incurred by field examiners, and the rest ($59.0 million and 43 percent of the total insurance relate costs) was incurred by other NCUA regional and central offices and could be treated as fixed/overhead costs. However, when the Imputed SSA Value is calculated, the costs that are based on the examination hours are imputed. The only consideration for the fixed/overhead cost is the additional cost that would have incurred by the Office of Human Resources for the additional hours spent by NCUA on the insurance activities for FISCUs. Consequently, since SSAs would have incurred certain level of fixed/overhead costs for its insurance activities, by treating the Imputed SSA Value as incremental NCUA

Since the ETS only covers FCUs, NCUA has to estimate the examination hours that would have to be incurred and the applicable percentage of these hours that would be incurred on "insurance-related" activities on FISCUs in the Imputed SSA Value calculation. Under the first step of the Imputed SSA Value calculation, the average examination hours for FCUs are summarized by asset size and CAMEL rating of FCUs. The average examination hours for FCUs in each asset size / CAMEL rating grouping are then multiplied by the corresponding number of FISCUs for the same asset size / CAMEL rating grouping in order to estimate the total examination hours that would have to be incurred on such FISCUs. The total of such estimated hours for all FISCUs across all asset size / CAMEL rating groupings is then calculated as the estimate of examination hours that would have to be incurred on all FISCUs.

Finally, the percent of "insurance-related" hours based on the ETS for the Federal Examination (Code 10) Program is applied to the total imputed FISCUs examination hours in order to calculate the total "insurance-related" hours that would have to be incurred on FISCUs. The inherent/implicit assumptions in the validity of this step in the Imputed SSA Value calculation are:

a) The percentage of total examination hours that is "insurance-related" does not systematically vary across credits unions that differ in terms of their asset size / CAMEL rating groupings (which is not the case as is discussed in section 5.2.2.1 and Table 2); and/or

b) The distribution of FCUs across asset size / CAMEL rating groupings is not dissimilar to the corresponding distribution for FISCUs such that results from one population can be extrapolated to the other.

Regarding the first assumption, the 2008-09 ETS results show that the bigger the credit union, the higher percentage of total examination hours that is "insurance-related" and the riskier the credit union according to the CAMEL rating, the higher percentage of total examination hours that is insurance-related. Therefore, the first assumption does not hold true.

If the second implicit assumption does not hold true such that the distributions of FCUs and FISCUs are significantly dissimilar, applying the overall percent of insurance related-hours for FCUs (which represents a weighted average across different "types" as captured by asset size / CAMEL rating groupings) to the total imputed examination hour for FISCUs would result in an inaccurate estimate that is skewed by factors specific to the population of FCUs and not shared by FISCUs.

In order to test the validity of this assumption, PwC compared the distribution of FCUs across asset size / CAMEL rating groupings with that for FISCUs as shown in Table 7 and Table 8 below.

Table 7: Distribution of FCUs by asset sizes and CAMEL ratings

FCUs (%) in each category (as of June 2009)	Assets <$10M	$10M - $100M	$100M - $250M	$250M - $500M	> $500M	TOTAL
CAMEL 1	4.0%	8.2%	2.3%	1.2%	1.6%	17.3%
CAMEL 2	25.7%	25.0%	4.4%	1.7%	1.3%	58.1%
CAMEL 3	12.3%	6.9%	1.0%	0.3%	0.3%	20.8%
CAMEL 4	2.2%	1.1%	0.1%	0.1%	0.1%	3.6%
CAMEL 5	0.1%	0.1%	0.1%	0.0%	0.0%	0.3%
TOTAL	44.4%	41.2%	7.8%	3.3%	3.2%	4,782/100%

Source: PwC computation based on data provided by NCUA

"insurance-related" costs, this step does not capture the true insurance costs incurred by SSAs and borne by FISCUs through operating fees.

Table 8: Distribution of FISCUs by asset sizes and CAMEL ratings

FISCUs (%) in each category (as of June 2009)	Assets < $10M	$10M - $100M	$100M - $250M	$250M - $500M	> $500M	TOTAL
CAMEL 1	4.4%	8.0%	1.9%	1.0%	2.2%	17.5%
CAMEL 2	20.8%	25.5%	5.4%	2.6%	2.8%	57.1%
CAMEL 3	8.9%	8.1%	2.6%	0.7%	0.8%	21.0%
CAMEL 4	1.3%	1.4%	0.7%	0.3%	0.5%	4.2%
CAMEL 5	0.0%	0.1%	0.0%	0.0%	0.0%	0.1%
TOTAL	35.5%	43.0%	10.6%	4.7%	6.3%	2,906/100%

Source: PwC computation based on data provided by NCUA

As the tables above illustrate, that the distributions for FCUs and FISCUs across asset size / CAMEL rating grouping is not dissimilar for the period in question. Consequently, using the overall percent of "insurance-related" hours based on the Examination Time Survey for FCUs to the total imputed FISCUs examination hour is not likely to undermine the accuracy of the results. Nevertheless, there is no certainty that this will continue to be the case in the future.

Conclusion

Based on PwC's review, the exclusion of an estimate of "fixed/overhead costs" that SSAs incur in their performance of "insurance-related" activities can lead to a potential underestimation of the Imputed SSA Value relative to the actual "insurance-related" costs incurred by the SSAs and borne by the FISCUs through the operating fees paid by them. Application of the overall percent of "insurance-related" hours based on the ETS implemented for FCUs to the total examination hours imputed for FISCUs in order to calculate an estimate of the total "insurance-related" hour for FISCUs is not unreasonable given that the distributions of FCUs and FISCUs across asset size and CAMEL ratings is not dissimilar.

Recommendations

The Imputed SSA Value is one of the most critical inputs to the OTR calculation and has an important bearing on how concerns related to equity between FCUs and FISCUs are addressed (as explained under the relevant section on equity below). To this end, the Imputed SSA Value should reflect an estimate of the "insurance-related" costs incurred by SSAs and borne by the FISCUs through the operating fees paid by them.

Ann estimate of SSAs' overhead-type costs should be incorporated in the current calculation of the Imputed SSA Value. The SSA fixed/overhead costs could be estimated as a percentage of the current Imputed SSA Value based on NCUA's estimate of SSAs' cost structure and a corresponding figure for NCUA.[14]

5.2.5. Insured Asset Shares

The basis used for allocating the total insurance costs between FCUs and FISCUs is the ratio of insured assets of FCUs and FISCUs respectively to the total insured assets of all credit unions (referred to in this document as the Insured Asset Shares). By using this as the allocation basis, the

[14] It is recommended that NCUA estimate the overhead-type costs that are incurred by SSAs and incorporate this estimate in the Imputed SSA Value computation. Due to the potentially excessive administrative burden associated with estimating this figure for each SSA (especially given the limited availability of data on specific SSAs), the overhead-type costs could be estimated by referencing NCUA's own cost structure. For example, it may be reasonable to assume that SSAs would have to incur overhead costs similar to NCUA's Office of the Chief Financial Officer and the Office of the Chief Information Office in their conduct of insurance related activities. The insurance related component of NCUA's costs for the Office of the Chief Financial Officer and the Office of the Chief Information Office were estimated as $1.5 million and $2.7 million respectively in the 2010 OTR calculation. This figure amounts to 5.4 percent of the insurance related cost incurred by the NCUA regional office and field ($79.7 million). Applying this percentage (i.e. 5.4 percent) to the cost of full time equivalent positions for FISCUs ($21.2 million) as determined under the Imputed SSA Value calculation, the SSAs' overhead-type costs can be estimated as $1.1 million.

"insurance-related" costs included in by the OTR "apportioned" between FCUs and FISCUs in a manner that mirrors the basis used to determine how premiums from NCUSIF are charged to the credit unions and how dividends are paid out. When NCUSIF transfers funds to NCUAOF through the OTR, the funds that are potentially available for dividends to be paid out to FCUs and FISCUs will decrease for each credit union in proportion to the credit union's insured assets. Similarly, in the case that NCUA assesses an insurance premium payment by FCUs and FISCUs to NCUSIF; the premium is paid as a percentage of the insured assets. Thus the "insurance-related" costs through the OTR are ultimately "borne" by FCUs and FISCUs by the effect it has on dividend paid by NCUSIF to the credit unions or the premium charged to them each of which is done on the basis of the credit union's insured assets. Thus, the OTR "burden" for FCUs and FISCUs is always proportional to their insured assets. Therefore, it is imperative that the OTR calculation takes into account the same asset allocation basis to allocate the insurance costs between FCUs and FISCUs which is consistent with the mechanism used for the determination of dividend payouts/premium charges.

The OTR is ultimately be "borne" by FCUs and FISCUs in proportion to their insured assets. If a different allocation basis was used to allocate the total insurance costs between FCUs and FISCUs, as discussed above, this would create a distortion between the insurance costs that were intended to be borne by FCUs and FISCUs (e.g. according to the different allocation base) and the true costs that would be borne by FCUs and FISCUs through the mechanism governing how the dividend or insurance premium is assessed.

Conclusion

Based on PwC's review, the use of the share of insured asset as the basis to allocate the insurance costs between FCUs and FISCUs was found to be reasonable and appropriate.

5.2.6. Sensitivity Analysis

The purpose of this section is to quantify the impact of changes in some of the inputs in the OTR calculation discussed above on the final OTR so as to indicate the relative importance of each of these inputs.

ETS Results

Table 9 and Table 10 provide the sensitivity of the OTR calculation due to variations in the ETS results for the Federal Examination Program or the Federal Supervision Program when the ETS results vary by five percentage points and ten percentage points. For the OTR calculation, an increase in the percentage of regulatory activities as determined from the ETS will decrease the amount of cost associated with NCUA insurance activities and will subsequently decrease both the OTR in percentage terms and the USD amount. Based on the sensitivity analysis, for the Federal Examination Program, a five percentage point increase in the percentage of regulatory related activities will result in a 0.8 percentage point decrease in the OTR and $1.5 million reduction in the USD amount of the OTR. Similarly, for the Federal Supervision Program, a five percentage point increase in the percentage of regulatory related activities will result in a 0.6 percentage point decrease in the OTR and $1.1 million reduction in the USD amount of the OTR. Similar results hold for the ten percentage point increase and decreases in the percentage of regulatory related activities.

Table 9: Sensitivity analysis - percentage of regulatory related activities (Federal Examination Program)

Change in percentage of regulatory related activities - Federal Examination Program	Change to percentage OTR	Change to USD amount OTR (in million USD)
-10%	1.5%	3.1
-5%	0.8%	1.5
+5%	-0.8%	(1.5)
+10%	-1.5%	(3.1)

Source: PwC computation based on data provided by NCUA

Table 10: Sensitivity analysis - percentage of regulatory related activities (Federal Supervision Program)

Change in percentage of regulatory related activities - Federal Supervision Program	Change to percentage OTR	Change to USD amount OTR (in million USD)
-10%	1.1%	2.2
-5%	0.6%	1.1
+5%	-0.6%	(1.1)
+10%	-1.1%	(2.2)

Source: PwC computation based on data provided by NCUA

Other Allocation Factors

Table 11 provides the sensitivity of the OTR calculation due to variations in the Other Allocation Factors for Other NCUA Cost Centers when these factors vary by five percentage points and ten percentage points, respectively. For the OTR calculation, an increase in the percentage of regulatory related activities for Other NCUA Cost Centers will decrease the amount of cost associated with NCUA insurance activities and will subsequently decrease both the OTR in percentage and the USD amount of the OTR. As shown in Table 6, the overall percentage of regulatory related activities was estimated to be 30.7 percent. Based on the sensitivity analysis, for Other NCUA Cost Centers, a five percentage point increase in the percentage of regulatory related activities will result in a 2.1 percentage point decrease in the OTR and $4.3 million reduction in the USD amount of the OTR. A ten percentage point increase in the percentage of regulatory related activities will result in a 4.2 percentage point decrease in the OTR and $8.5 million reduction in the USD amount of the OTR.

Table 11: Sensitivity analysis - percentage of regulatory related activities (Other Allocation Factors)

Change in percentage of regulatory related activities - Other Allocation Factors	Change to percentage OTR	Change to USD amount OTR (in million USD)
-10%	4.2%	8.5
-5%	2.1%	4.3
+5%	-2.1%	(4.3)
+10%	-4.2%	(8.5)

Source: PwC computation based on data provided by NCUA

Imputed SSA Value

The 2008-09 Imputed SSA Value was calculated to be $21.1 million. For the OTR calculation, an increase in the amount of the Imputed SSA Value will increase the Total System Insurance Costs and subsequently increase the amount of costs on the insurance activities allocated to credit unions according to the Insured Asset Share. An increase in the amount of the Imputed SSA Value also translates into an increase in the amount of the insurance costs borne by FISCUs through operating fees paid to SSAs. With only a portion of the increase in Imputed SSA Value allocated to FISCUs and the amount of insurance costs borne through operating fees increased by the whole amount of the increase in the Imputed SSA Value, the amount of the insurance costs borne through the OTR by FISCUs will decrease. Subsequently, the OTR in percentage terms and the USD amount of the OTR will decrease with the increase in the amount of the Imputed SSA Value.

Table 12 provides the sensitivity of the OTR calculation due to variations in the Imputed SSA Value when this value varies by $3.0 million, $5.0 million and $10.0 million, respectively. Based on the sensitivity analysis, a $5.0 million increase in the amount of the Imputed SSA Value will result in a 3.0 percentage point decrease in the OTR and $6.0 million reduction in the USD amount of the OTR. Similar results hold for the $3.0 million and $10.0 million increase and decreases in the amount of Imputed SSA Value.

Table 12: Sensitivity analysis - Imputed SSA Value

Change in Imputed SSA Value (in million USD)	Change to Percentage OTR	Change to USD amount OTR (in million USD)
(10.0)	6.0%	12.0
(5.0)	3.0%	6.0
(3.0)	1.8%	3.6
3.0	-1.8%	(3.6)
5.0	-3.0%	(6.0)
10.0	-6.0%	(12.0)

Source: PwC computation based on data provided by NCUA

5.3. Equity

Equity considerations require that the calculation and administration of the OTR should not, ex-ante and for reasons beyond the control of the credit unions, favour or disadvantage one type of credit union (i.e. federal versus state chartered) over another. FCUs indirectly "bear" "insurance-related" costs through the OTR that is administered by NCUAOF for NCUSIF (and which impacts the amount of premiums charged or dividends paid) as well as directly through the operating fees paid by FCUs to the NCUA. Similar to this, FISCUs indirectly "bear" "insurance-related" costs incurred by NCUA through the OTR that is administered by NCUAOF for NCUSIF as well as directly bear the "insurance-related" costs incurred by the respective SSAs through the operating fees charged by them.

A widespread concern in industry, especially among FISCUs and the associated industry groups, is that the existing calculation and administration of the OTR inherently disadvantages FISCUs relative to FCUs. The basis for this concern is the argument that a higher OTR (due to a higher proportion of NCUA's budget being characterized as "insurance-related" costs) adversely affects both FCUs and FISCUs through its impact on premiums charged (or dividends paid) by NCUSIF (on the basis of Insured Asset Shares). In addition, the higher OTR specifically and favourably affects FCUs through a one-for-one reduction in their operating fees (given that a higher proportion of the NCUA budget is covered by the OTR). Under this view, a higher OTR (through an overestimation of the NCUA budget's composition of "insurance-related" costs) effectively amounts to a cross-subsidy by the FISCUs (that are insured by NCUA through NCUSIF but chartered and regulated by state authorities) to the FCUs (that are insured as well as chartered and regulated by NCUA).

In order to assess the validity of this concern, PwC reviewed the OTR Methodology, specifically with respect to the steps associated with the calculation of the Imputed SSA Value to highlight the following observations:

- First, the inclusion of the Imputed SSA Value step ensures that of NCUA's total costs that are determined to be "insurance-related" ($140.3 in 2010) only a portion ($115.0 in 2010) are received via the OTR while the remainder ($25.3 million in 2010) is recovered only from FCUs through the operating fees paid by them;

- Second, the higher the Imputed SSA Value, with all other factors held constant, the greater the amount of NCUA's total "insurance-related" costs that are recovered solely from FCUs through their operating fees;
- Third, the factors that result in a higher portion of NCUA's budgeted costs being classified as "insurance-related" (e.g. ETS results) are also used in the calculation of the Imputed SSA Value; and,
- Finally, to the extent that the Imputed SSA Value is an unbiased and fair estimate of the "insurance-related" costs incurred by SSAs on the FISCUs, the OTR Methodology yield an equitable outcome in terms of the proportion of "insurance-related" costs "borne" by the FCUs and FISCUs, respectively, through the OTR versus that which is paid for by them via their respective operating fees paid to the separate regulators.

PwC reviewed the OTR calculation and found that the OTR calculation is designed to ensure that insurance costs borne through the operating fees and the overhead transfer is the same for FCUs and FISCUs if the Imputed SSA Value provides a reasonable estimate of the insurance costs incurred by SSAs and borne by FISCUs through operating fees. FCUs and FISCUs are paying a part of the insurance costs through the overhead transfer and are paying the rest through their operating fees to NCUA and SSAs. Table 13 below shows that with respect to the 2010 OTR, the ratio of the "insurance-related" costs borne through the OTR relative to the total insurance costs (i.e. including that which is paid for via the respective operating fees) is the same for FCUs and FISCUs, *to the extent that the Imputed SSA Value is a reasonable estimate of the actual SSA "insurance-related" costs.*

Table 13: FCUs and FISCUs insurance costs

Based on 2010 OTR calculation (in million USD)	Formula	Total	FCUs	FISCUs
[illegible]	a	140.3		
Imputed SSA Value	b	21.1		
[illegible]	c=a+b	161.3		
Percent of insured shares	d		54.6%	45.4%
[illegible]	e=c*d		88.1	73.3
2010 overhead transfer to NCUSIF	f	115.0		
[illegible]	g=f*d		62.8	52.2
Insurance costs borne through operating fees	h=e-g		25.3	21.1
Percent of insurance costs through the OTR to total	i=g/(g+h)		71.3%	71.3%

Source: PwC computation based on data provided by NCUA.

Additionally, in order to evaluate the concern among FISCUs and associated industry groups, PwC analyzed the ratio of total operating fees to total insured assets (the "Operating Fee to Insured Asset Share") for the FCUs and compared this to the corresponding ratio for FISCUs. While this comparison is clouded by the differences between regulations governing the chartering of FCUs versus those for FISCUs, it was nevertheless applied under the view that if the OTR Methodology inherently favoured the FCUs versus FISCUs, this is likely to be reflected in a lower Operating Fee to Insured Asset Share for FCUs relative to FISCUs.[15]

Table 14 below shows the Operating Fee to Insured Asset Share for FCUs and FISCUs for 2007 through 2009. Based on this there does not appear to be a reasonable basis to conclude that the OTR favors one type of credit unions over another.

[15] The state operating fees are the cumulative fees across all state charters. The aggregate fees, to some extent, mitigate the concerns associated with the variability across states.

Table 14: Operating fee to Insured Asset Share (2007 - 2009)[16]

% Operating fees / Amount of insured asset shares	FCUs	FISCUs
2007	0.0207%	0.0195%
2008	0.0201%	0.0214%
2009	0.0206%	0.0171%
Average 2007 - 2009	0.0205%	0.0192%

Source: PwC computation based on data provided by NCUA

Conclusion

Based on PwC's review, there was no reasonable basis to conclude that the OTR Methodology ex-ante and for reasons beyond the control of the credit unions, favours or disadvantages any one type of credit unions (i.e. federal versus state chartered) over another.

5.4. Reasonable Administrative Burden

The OTR Methodology needs to balance the objectives of transparency, accuracy and equity as listed above, while keeping costs of implementation manageable. The OTR Methodology should be easily implementable without any unnecessary and unrealistic administrative burden.

Conclusion

Based on PwC's review, even though the calculation methodology is a multi-layered complex algorithm, the costs and burdens of implementation were not viewed by management as significant impediments.

[16] Appendix B presents the 2007 - 2009 financial data used for the calculation.

6. Conclusion

6.1. Overview of Approach

PwC has been engaged by NCUA to evaluate the OTR administered between NCUAOF and NCUSIF. To complete this study PwC undertook the following steps:

1) Conducted interviews with and requested key information from NCUA personnel identified as being relevant in order to develop a comprehensive understanding regarding the NCUA's OTR Methodology, the constituent steps and underlying assumptions;

2) Identified and conducted interviews with "key stakeholders" in the U.S. credit union system that included credit unions and trade associations for federal and state charter credit unions as well as that for the state regulatory authorities;

3) Identified the stakeholders' views on attributes that an appropriate OTR Methodology should possess as well as the concerns and issues with regards to the current OTR Methodology as perceived by these stakeholders;

4) Developed a set of criteria to evaluate the current OTR Methodology based on the concerns and issues identified by the key stakeholders; and

5) Evaluated NCUA's current OTR Methodology against the set of criteria so as to arrive at a conclusion on the soundness and reasonableness of the current OTR Methodology and develop recommendations and suggestions for improvement.

Based on the interviews and the material, PwC identified the following criteria for purposes of evaluating the current OTR Methodology and recommending possible revisions/amendments/modifications for NCUA's consideration:

1) Transparency - The OTR Methodology and its underlying steps, assumptions and data sources should be communicated clearly and regularly to stakeholders in the credit union system so as to develop broad and consistent understanding among them. Of fundamental importance to the computation of the OTR is the distinction between activities and associated expenses deemed to be associated with NCUA's role in managing the NCUSIF (i.e. expenses that can be characterized as being "insurance related" and thus included in the OTR) and others classified as those in keeping with the NCUA's role as regulator (and thus excluded from the OTR). Given this, the OTR Methodology should be based on a classification that represents a consensus (among the NCUA and other stakeholders in the credit union system) with regards to such activities.

2) Accuracy - Subject to the classification of activities as "insurance related" and others, the calculation of the OTR should be predicated on a methodology that is able to measure and track the expenses associated with such activities accurately and consistently across different regions and over time.

3) Equity - The calculation and administration of the OTR should not, ex-ante, favour or disadvantage one type of credit unions (i.e. federal versus state chartered) over another.

4) Reasonable administrative burden - The OTR Methodology needs to be such as to balance the objectives of criterion 1 through 3 while keeping costs of implementation manageable.

6.2. Summary of Conclusions

The findings and conclusions of this study, which are based on the analysis of all available facts and circumstances, are as follows:

6.2.1. Transparency

Based on PwC's review, the OTR Methodology was considered lacking in terms of the extent to which the classification of NCUA's activities between insurance and regulatory (upon which the methodology is fundamentally dependent) represents a consensual view on such a characterization in the industry. Further, there was found to be dissatisfaction within the industry with respect to NCUA's efforts to communicate and explain the OTR Methodology in adequate detail.

It is recommended that NCUA consider providing more visibility on how it characterizes its activities to the different industry groups and credit unions and possibly solicit their feedback with regards to the reasonableness and accuracy of the classification. NCUA should also consider steps aimed at making the methodology itself more transparent, along with all of the assumptions and steps that are utilized. Possible ways of achieving this include more frequent interactions with the stakeholders through different channels (e.g. meeting, publications, etc.).

6.2.2. Accuracy

PwC analyzed the following five elements from the perspective of their ability to accurately and consistently "measure" the expenses associated with the management of NCUSIF incurred on behalf of all federally-insured credit unions:

6.2.2.1. Implementation of Examination Time Survey - Education and Training of Examiners

Based on PwC's review, the current definition of insurance and regulatory activities is appropriately communicated to the examiners through well-structured tools and training modules. The process provides enough resources available for examiners to learn about how to fill the Examination Time Survey.

6.2.2.2. Examination Time Survey Reliability

Based on PwC's review, the statistical methodology used by NCUA to estimate the non-insurance percentage of workload hours for each program in order to determine the OTR can be considered reasonable. While the sampling methodology obtains representation across regions, SE Groups, PEs, work hours and federal credit unions, it can be improved with respect to the representativeness of the distribution of credit unions by asset size in the sample relative to the population.

In order to obtain a more representative sample, it is recommended that consideration of sample allocation by asset size and CAMEL rating should be taken into account as there appears to be some correlation between these characteristics and the percent of "insurance-related" work hours. Additionally, it is recommended that NCUA use sample sizes that are consistent with the calculated sample sizes for both programs under survey, and specifically, that NCUA consider increasing the sample sizes for the Federal Supervision (Code 22) Program.

6.2.2.3. Other Allocation Factors

Based on PwC's review, the Other Allocation Factors used to determine the insurance/regulatory percentage of costs for Other NCUA Cost Centers were not found to be based on methods that can be considered as objective and verifiable as the ETS results used to determine the equivalent split for examiner costs. Given that these costs for Other NCUA Cost Centers constitute a significant portion of NCUA's overall budget, the final OTR as determined based on these Other Allocation Factors as an input can potentially be "distorted".

Conclusion

It is recommended that NCUA consider adopting a more formal and documented process for determining the Other Allocation Factors that are based on standard and consistent criteria.

6.2.2.4. Imputed SSA Value Calculation

Based on PwC's review, the exclusion of an estimate of "overhead-type costs" that SSAs incur in their performance of "insurance-related" activities can lead to a potential underestimation of the Imputed SSA Value relative to the actual "insurance-related" costs incurred by the SSAs and borne by FISCUs through the operating fees paid by them. Application of the overall percent of "insurance-related" hours based on the ETS implemented for FCUs to the total examination hours imputed for FISCUs in order to calculate an estimate of the total "insurance-related" hour for FISCUs is not unreasonable given that the distributions of FCUs and FISCUs across asset sizes and CAMEL ratings is not dissimilar.

It is recommended that the Imputed SSA Value should reflect an estimate of the "insurance-related" costs incurred by SSAs and borne by FISCUs through the operating fees paid by them. An estimate of SSAs' overhead-type costs should be incorporated in the current calculation of the Imputed SSA Value. The estimate of SSAs' overhead-type costs could be calculated as a percentage of the current Imputed SSA Value based on a corresponding figure for NCUA.

6.2.2.5. Insured Asset Shares

Based on PwC's review, the use of insured assets as the basis to allocate the insurance costs between FCUs and FISCUs was found to be reasonable and appropriate.

6.2.3. Equity

Based on PwC's review , there was no reasonable basis to conclude that the OTR methodology ex-ante and for reasons beyond the control of the credit unions, favours or disadvantages any one type of credit unions (i.e. federal versus state chartered) over another.

6.2.4. Reasonable Administrative Burden

Based on PwC's review, even though the calculation methodology is a multi-layered complex algorithm, the costs and burdens of implementation were not viewed by management as significant impediments.

Appendix A. 2010 OTR Calculation Steps

The following provides the 2010 OTR calculation steps from the NCUA Board Action Memorandum on 2010 OTR dated November 19, 2009.

STEP 1 – Workload Program (2010)

Core Programs	2010 Workload Hours	Non-Insurance Percent	Non-Insurance Hours	Allocation Basis
Federal Examination	369,750	40%	149,342	Examiner time survey.
Federal Supervision	105,850	33%	34,645	Examiner time survey.
State Exam & Supv	130,784	0%	0	FISCU work is insurance-related.
State Exam Review	7,963	0%	0	FISCU work is insurance-related.
5300 Program	50,518	22%	11,139	FCU time uses examiner time survey. FISCU portion at all insurance-related.
Total Core Program	**664,865**	**n/a**	**195,125**	
Special Programs				
Fair Lending Exams	3,000	100%	3,000	Regulatory program.
Agricultural Lending	364	0%	0	NCUSIF risk management program.
FOM & Chartering	403	100%	403	Regulatory program.
RCMS	5,200	0%	0	NCUSIF risk management program.
RISOs	1,500	40%	606	Allocation based on % from time surveys.
Small Credit Unions	19,484	90%	17,629	For FCUs is a regulatory program. However, approximately 10% of the time in this program is related to work in FISCUs.
CUSO Exams	1,500	0%	0	NCUSIF risk management program.
Total Special Program	**31,451**	**n/a**	**21,638**	
Total Core & Special Programs	**696,316**	**n/a**	**216,763**	
Percent of Workload Programs devoted to NCUA's Non-Insurance Role			31%	

STEP 2 – Financial Budget (2010)

Cost Area 2010 Financial Budget	Dollar Budget ($M)	Non-Insurance Percent	Non-Insurance Cost ($M)
Divisions of Insurance: Primarily non-insurance (regulatory) function involving chartering and fields of membership, net of work related to share insurance coverage for members and FISCUs.	$5.1	71%	$3.6
All Other Region Costs: Based on non-insurance related portion of core and special workload programs.	$115.8	31%	$36.0
Asset Management Assistance Center and Assistance Program: NCUSIF function that handles liquidation payouts, manages assets acquired from liquidations and assistance programs, and manages recoveries for the National Credit Union Share Insurance Fund.	$3.5	0%	$0.0
Office of Small Credit Unions: Primarily non-insurance related function to facilitate the expansion of credit union services. However, 10% FISCU participation rate.	$5.3	90%	$4.8
Office of Corporate Credit Unions: NCUSIF risk management function other than chartering, FOM, and mergers.	$7.9	20%	$1.6
Office of Chief Financial Officer: Based on non-insurance percent, net of staff time associated with NCUSIF accounting.	$7.7	20%	$1.5
Office of Chief Information Officer: Combination of support for state and federal examiners and staff related to hardware and software, as well as efforts for program development driven by Examination and Insurance.	$13.7	20%	$2.7
Office of Human Resources: Based on non-insurance percent, adjusted for Division of Training and Development time related to training for state examiners and staff.	$10.7	20%	$2.1
All Other Costs: Based on non-insurance portion of core and special workload programs. Includes NCUA board, Office of Inspector General, etc.	$31.3	31%	$9.7
Total 2010 NCUA Budget	$200.9		$62.2

NOTE: The totals may not reconcile due to the results of rounding.

STEP 3 – Calculate NCUSIF Costs (2010)

Imputed NCUSIF Costs

	Millions
2010 Financial Budget	$200.9
Non-Insurance Costs (see Step 2)	- $62.2
SSA imputed Value	+ $21.1
Direct Operational Charges to NCUSIF	+ $1.6
Total NCUSIF Imputed Costs	**= $161.3**

STEP 4 – Allocation of NCUSIF Costs (2010)

Insured Shares Allocation

	FCU	FISCU
Total Cost of Providing NCUSIF Insurance	$161.3	$161.3
Times Proportional Allocation Basis	54.6%	45.4%
Equals Allocated Insurance Costs	**$88.1**	**$73.3**

Net of Imputed SSA Value

	Millions
Total Allocated Insurance Costs - FISCUs	$73.3
Minus SSA Insurance Work Imputed Value	$21.1
Equals Net Cost of NCUSIF Insurance – FISCUs	**$52.2**

Dollar Amount of OTR

	FISCUs	FCUs	Dollar Amt
FISCU Portion of NCUA Insurance Cost	$52.2M	$62.8M	115.0M
Divided by Percentage of Insured Shares	45.4%	54.6%	

OTR as a Percent of Budget

Dollar Amount of OTR	$115.0M
Divided by NCUA Budget	$200.9M
Equals OTR	**57.2%**

Imputed SSA Value Step 1 – 2010

Gross Workload

Table 1

Average Exam Time (Hours) FCU (Dec 2009)	Assets < $10M	$10M – $100M	$100M – $250M	$250M – $500M	> $500M
CAMEL 1	46	78	144	193	310
CAMEL 2	51	89	168	208	322
CAMEL 3	56	109	202	278	326
CAMEL 4	67	167	333	351	381
CAMEL 5	96	167	399	351	381

Table 2

FISCUs (#) in Each Category (as of June 2009)	Assets < $10M	$10M – $100M	$100M – $250M	$250M – $500M	> $500M
CAMEL 1	128	232	56	30	63
CAMEL 2	604	740	157	77	82
CAMEL 3	260	234	75	20	22
CAMEL 4	39	41	19	9	14
CAMEL 5	0	2	1	0	1

Table 3

Total Hours (Table 1 cells x Table 2 cells)	Assets < $10M	$10M – $100M	$100M – $250M	$250M – $500M	> $500M
CAMEL 1	5,888	18,096	8,064	5,790	19,530
CAMEL 2	30,804	65,860	26,376	16,016	26,404
CAMEL 3	14,560	25,506	15,150	5,560	7,172
CAMEL 4	2,613	6,847	6,327	3,159	5,334
CAMEL 5	0	334	399	0	381
Total	53,865	116,643	56,316	30,525	58,821
			Total Gross	Exam Hours	316,170

Imputed SSA Value Step 2 - 2010

Net Workload

Net of Insurance-Related Time

FISCUs	Hours
Gross FISCU Exam Hours	316,170
x Insurance Factor Based on Exam Time Survey	59.6%
= Total Insurance Hours w/out Risk-Based Scheduling	188,469

Net of Risk-Based Scheduling

	Hours
Total Insurance Hours w/out Risk-Based Scheduling	188,469
- Not Eligible for Deferral Hours	181,084
= Eligible for Deferral	7,385
x Adjustment for Risk-Based Scheduling	66.7%
= Annual Eligible for Deferral Hours	2,462
+ Not Eligible for Deferral Hours	181,084
+ Adjustment for Additional Supervision	978
= Total FISCU Hours with Risk-Based Scheduling	186,986

Net of NCUA Time in FISCUs

	Hours
Total FISCU Hours with Risk-Based Scheduling	186,986
+ 2010 Budgeted Supervision Hours	40,242
- 2010 Budgeted Insurance Review Hours	90,542
- 2010 Budgeted State Exam Report Review Hours	7,963
Total Additional FISCU Insurance Hours Needed	**128,723**

Imputed SSA Value Step 3 - 2010

Additional Staff Needed

Examiner Productive Time

2010 Core and Special Workload Program Hours	696,316
/ Total 2010 Workload Program Hours	1,272,649
= Productivity Ratio	54.7%
Total Work Hours in a Year Per Full Time Equivalent (FTE)	2,080
x Productivity Ratio	54.7%
= Productive Hours per FTE Examiner	1,138

Number of Examiners Needed

Net Additional FISCU Hours Needed	128,723
/ Productive Hours per FTE Examiner	1,138
= Number of Additional FTE Examiners Needed	113.1

Total Additional Staff Needed

Additional Staff Needed	Ratio Examiners to Position	FTEs Per Position
Examiners	1/1	113.1
Supervisory Examiners	1/9	12.6
Analysts	1/15	7.5
Directors	1/25	4.5
Other Regional Staff	1/20	5.7
= Number of Additional FTEs Needed		143.4

Imputed SSA Value Step 4 - 2010

Imputed Cost

Gross Cost

Total Cost of Regions (2010 Budget)	$120,860,762
/ FTEs in Regions (2010 Budget)	816.25
= Per Regional FTE Cost	$148,068
x Number of Additional FTEs Needed	143.4
= Cost of Additional Regional Positions	$21.2M

Net Cost

	Millions
Cost of Additional Regional Positions	$21.2
+ Additional OHR Costs (12.9% of $10.7 million budget)	$1.4
- SSA Training and Equipment Cost	$1.6
= Imputed SSA Value	**$21.1**

Appendix B. 2007, 2008 and 2009 Operating Fee to Insured Asset Share

Table B-1: 2007 Operating fee to Insured Asset Share

2007 (in million USD)	Total	FCUs	FISCUs
Operating fee		64.0	49.1
Amount of insured asset shares	560,832	308,917	251,915
Percent of insured asset shares		55.1%	44.9%
% Operating fee /Insured Asset Share		**0.0207%**	**0.0195%**

Table B-2: 2008 Operating fee to Insured Asset Share

2008 (in million USD)	Total	FCUs	FISCUs
Operating fee		72.4	64.0
Amount of insured asset shares	658,900	360,418	298,482
Percent of insured asset shares		54.7%	45.3%
% Operating fee /Insured Asset Share		**0.0201%**	**0.0214%**

Table B-3: 2009 Operating fee to Insured Asset Share

2009 (in million USD)	Total	FCUs	FISCUs
Operating fee		81.7	56.2
Amount of insured asset shares	724,800	395,741	329,059
Percent of insured asset shares		54.6%	45.4%
% Operating fee /Insured Asset Share		**0.0206%**	**0.0171%**

Table B-4: Average 2007 - 2009 Operating fee to Insured Asset Share

Average 2007 - 2009 (in million USD)	Total	FCUs	FISCUs
Operating fee		72.7	56.4
Amount of insured asset shares	648,177	355,025	293,152
Percent of insured asset shares		54.8%	45.2%
% Operating fee /Insured Asset Share		**0.0205%**	**0.0192%**

Source: PwC computation based on data provided by NCUA and data from 2007, 2008 and 2009 NCUA financial statements

House Subcommittee on Financial Institutions and Consumer Credit
Hearing on National Credit Union Administration Operations and Budget
July 23, 2015

Questions for Debbie Matz, Board Chairman, National Credit Union Administration, from Congressman Mick Mulvaney

1. ***Chairman Matz, during the hearing you said several times that credit unions do not represent their members. This was startling news for me to hear, as well as for a number of other Subcommittee members. I'm sure the credit unions were equally shocked, and public statements from credit union CEOs and trade organizations bore that out in the days following the hearing. Since making those statements, you released a statement to apologize to the credit unions, but not to the members of the Committee for your statement or your demeanor. Chairman Matz, do you also apologize to the Subcommittee? How do you explain your remarks and follow-up statements?***

My statements on this issue at the hearing were made specifically in the context of discussing credit union participation in the preparation of NCUA's operating budget. I believe credit unions, in general, represent their members' interests extremely well. It was certainly not my intention to offend any members of the Subcommittee, credit union managers, or trade association executives.

During my testimony, I emphasized the importance of NCUA being an independent regulator that protects the deposits of more than 100 million credit union members. In order to do so, I believe that NCUA must be staffed adequately and have independent control of the agency's budget. I made the point that, in my opinion, stakeholder involvement in NCUA's budget process could ultimately undermine the ability of this agency to protect the nearly $1 trillion in savings entrusted to the more than 6,100 credit unions NCUA insures. Reducing NCUA's budget and examination program could end up costing those members in the event of another financial crisis. In this context, I do not believe that a credit union supporting reduced examiners and NCUA exam hours is necessarily representing the best interests of its members nor the credit union system's overall safety and soundness.

Regrettably, some observers construed my comments as a lack of faith in credit union leadership, which is not at all what I intended and not what I believe. It is for that misconception that I apologized.

I have served two terms on NCUA's Board. I have been an executive vice president and chief operating officer at a large credit union. I have a deep belief in the importance of member-owned credit unions offering affordable services to millions of Americans, and I am dedicated to protecting the credit union system and the members who belong to credit unions.

I believe firmly that the public has every right to expect government agencies to operate prudently, effectively, and at a reasonable cost. NCUA and the credit union system paid billions of dollars in losses for years of cost-cutting before the Great Recession that hindered our ability to do our jobs during the financial crisis. Cleaning up that disaster and retooling to prevent its recurrence required investment in staff, training, and tools to do the job right. I have always insisted every NCUA office justify every expense, and I will continue to do that. At the same time, I will continue to make protecting credit unions and their members' savings my top responsibility.

I do want to make clear, however, that I take very seriously the agency's dual mission as insurer and regulator to provide through regulation and supervision, a safe and sound credit union system. I also am a firm believer in transparency. To that end, NCUA is a peer leader in budget transparency. The budget resource page on NCUA's website provides over 80 documents detailing, among other things, line-item budgets for each staff office.[1]

2. ***I frequently hear from credit union members and officers in South Carolina that they want the NCUA to be run effectively to assure safety and soundness. However, these members also expect efficiency from NCUA just as NCUA expects it from the credit unions. Funds that are extracted from credit unions to pay for NCUA expenses are dollars that could have been used to fund loans or support other member-related activities. Do you still believe that the agency's budget is not a credit union interest or concern? Please explain why or why not.***

First, I agree that every credit union should be a careful steward of its members' funds. Likewise, NCUA has a responsibility to be a careful, efficient, and effective steward of both the Share Insurance Fund and the money it receives to fund its operations from credit unions.

It is understandable that any credit union would want to minimize its costs, including NCUA's budget. However, keep in mind that NCUA's annual budget represents only 0.02 percent of credit union assets.

An underfunded regulator is not in the best interests of the credit union members whose life savings are protected by well-trained examination staff with the resources to conduct thorough safety and soundness exams. In fact, based on 10 years of conversations with credit union volunteers and management across this country, they seem to understand that.

Since the hearing, even with all the subsequent credit union trade group and trade press attention to the budget hearing issue, I can note for the record that I have received only six letters from credit unions expressing any concerns about the NCUA budget, including five letters from California and Nevada with points very similar to documents produced by trade associations. That stands in stark contrast to the volume of letters and comments I receive regularly in support of removing regulatory and statutory barriers, such as to facilitate member business lending or expand field-of-membership rules.

So, in summary, I believe the NCUA budget is a concern for trade associations and perhaps some credit unions, but it is neither a top-tier nor a top-of-mind issue for the vast majority of credit union officials, given other priorities and regulatory burden challenges they face. In fact, as stated above, the NCUA budget represents only two basis points of total credit union assets.

[1] See http://www.ncua.gov/about/Pages/budget.aspx.

3. ***Chairman Matz, I would like to follow up on our previous discussion concerning the Overhead Transfer Rate (OTR). In light of the PriceWaterhouseCoopers (PwC) report citing deficiencies in the agency's process for determining the OTR, what steps is the agency planning to take to improve its transparency and accountability, at least as they relate to the OTR? Please provide details and timelines for implementing these steps.***

During my testimony at the hearing, I announced that NCUA will formally invite credit union stakeholders and the public to comment on the methodology for calculating the overhead transfer rate. At the end of August, I then announced my intent to simultaneously invite public comments on the methodology for calculating the federal credit union operating fee, which funds the portion of the NCUA budget that is not covered by the overhead transfer.

Specifically, I intend to call for a Board vote in January 2016 to publish both methodologies as public notices in the *Federal Register*. While these methodologies do not require notice–and-comment procedures based on the opinion of our Office of General Counsel, the notices will provide additional measures of transparency by making the process behind the agency's two primary funding mechanisms more formally available for public comment. The process typically takes six to nine months, including at least a 30-day comment period, consideration of the comments and staff recommendations for NCUA Board review and action.

Publication in January 2016 would provide ample time for interested parties to share their views before the Board considers a 2017 budget during a discussion to be scheduled for the November 2016 open meeting.

We also plan in January 2016 to release for comment a draft of NCUA's multi-year strategic plan. This plan drives the budget development process over several years. As always, public comment from credit union stakeholders on the strategic plan will be solicited.

4. ***I understand that the National Association of State Credit Union Supervisors commissioned a legal study which concludes that the overhead transfer rate is a "rule" subject to the Administrative Procedure Act and that NCUA's current procedure to implement the OTR violates the APA. Have you reviewed this study and do you believe the OTR is subject to APA notice and comment requirements? Why or why not?***

We have reviewed the paper commissioned by the National Association of State Credit Union Supervisors. NCUA's General Counsel advises that the overhead transfer rate is not subject to the notice-and-comment requirements of the Administrative Procedure Act. I have attached our General Counsel's response to the National Association of State Credit Union Supervisors, dated August 18, 2015. The unredacted response is also posted on the NCUA website.[2]

At your request, staff with NCUA's Office of General Counsel are available to discuss this issue further.

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[2] See http://www.ncua.gov/Legal/OpinionLetters/OL2015-0818.pdf.

5. ***The OCC, FDIC, and Federal Reserve Board follow the APA notice and comment process in determining the methodology and/or amount of their assessments and fees. Given that the OTR seems to have a substantial impact on the allocation of costs across the credit union system, why has NCUA declined to submit the OTR methodology and rate to the notice and comment process? Please provide copies of any and all documentation relating to any opinions you have relied on in determining not to submit the OTR methodology to the notice and comment process.***

The NCUA General Counsel's August 18 letter referenced in the answer immediately above outlines the specific legal reasons why NCUA is not required to submit the overhead transfer methodology and rate to the Administrative Procedure Act's formal notice-and-comment process. In addition, methodologies and other information about the overhead transfer rate and federal credit union operating fee are already available to the public on the budget resource center of NCUA's website.[3]

To provide even more transparency, as noted earlier, I have announced my intention to call for an NCUA Board vote in January 2016 to publish in the *Federal Register* the methodologies for calculating both the overhead transfer rate and the federal credit union operating fee. Through this publication, the agency will be formally inviting credit union stakeholders and the public to comment on both methodologies. Publication at the start of next year will provide ample time for interested parties to share their views before the NCUA Board considers a 2017 budget at an open meeting to be scheduled for November 2016.

Also as noted earlier, I intend to call for an NCUA Board vote in January 2016 to publish in the *Federal Register* a draft of NCUA's multi-year strategic plan, which will drive the agency's budget process over several years.

In addition to the NCUA General Counsel's recent response to the National Association of State Credit Union Supervisors about the overhead transfer rate, agency attorneys prepared an internal memorandum relating to the applicability of the Administrative Procedure Act's notice–and-comment provisions to the overhead transfer rate. This memorandum is protected by the attorney-client privilege and, accordingly, is not included those in this response. Attorneys from NCUA's Office of General Counsel, however, are available to meet with your staff in person to discuss the memorandum.

6. ***Generally speaking, an increase in the Overhead Transfer Rate has aligned with a decrease in operating fees for federal credit unions. Does NCUA's determinations regarding which activity is "insurance related" have a direct impact on the cost of holding a federal charter? If so, how does NCUA manage that potential conflict of interest when making adjustments to the OTR methodology?***

NCUA has used the overhead transfer rate since 1973, beginning with the adoption of federal share insurance for credit unions. The overhead transfer rate is designed to cover NCUA's costs of examining and supervising the risk to the Share Insurance Fund posed by all federally insured credit unions, as well as the costs of administering the Share Insurance Fund. Stated simply, the

[3] See http://www.ncua.gov/about/Pages/budget.aspx.

overhead transfer rate represents the percentage of the agency's incurred operating expenses paid for by a transfer from the Share Insurance Fund. Federally insured credit unions are not billed for, and do not have to remit, the overhead transfer rate amount.

In response to suggestions from trade associations, the NCUA Board in 2003 adopted a new methodology for calculating the overhead transfer rate. This methodology, with various refinements, has been in place ever since. In 2011, NCUA contracted with PricewaterhouseCoopers to independently review the overhead transfer rate methodology and its supporting rationale. The report found the methodology was reasonable and favored neither federally chartered nor state-chartered credit unions.

This is a critical point. To be equitable, the overhead transfer rate methodology should be neutral with respect to charter choice. To achieve this, NCUA assigns an imputed value to the work done by state regulators supervising federally insured, state-chartered credit unions. In the methodology, the imputed state regulator value reduces the overhead transfer rate, and the amount is calculated on the same cost basis as the work NCUA performs supervising federal credit unions.

Following the publication of the 2011 PricewaterhouseCoopers report, trade groups urged NCUA to further clarify and refine the definition of "insurance-related activities" and "non-insurance activities." They requested that NCUA provide more accuracy and consistency when examiners recorded their time. In response, NCUA conducted a regulation-by-regulation review in 2012 to make the application of the time survey definitions more explicit. NCUA classified each regulation and related examination activity as either insurance-related, insurance regulatory-related, or consumer regulatory-related.

In 2013, NCUA again contracted with PricewaterhouseCoopers to independently review the refinements. The 2013 report found the agency's 2012 refinements more clearly and correctly describe examination of insurance-related and non-insurance activities.

NCUA conducts an examination time survey each year using a statistically relevant sample of federal credit unions. The examination time survey definition refinements have resulted in more precise and consistent recording of examination time. The results of these surveys are used to determine the amount of time allocated to insurance- and non-insurance-related activities.

Examiner time is the main driver in calculating the overhead transfer rate, and examiners are spending the bulk of their examinations on insurance-related matters. As a result, the overhead transfer rate increased in 2015. The overhead transfer rate applied to the NCUA budget determines the amount of the budget applicable to insurance-related activities to be transferred from the Share Insurance Fund.

In addition to the overhead transfer, NCUA's Operating Fund is financed through assessment of annual fees to federally chartered credit unions. The total amount collected through the operating fees is calculated by subtracting the overhead transfer from the total NCUA budget. The operating fee is allocated to federally chartered credit unions based on their asset size as of the prior December 31. The fee is designed to cover the costs of providing administration and service, as well as regulatory examinations to the federal credit union system. NCUA's Board reviews the fee structure annually.

An increase in the overhead transfer rate will result in a lower operating fee for federally chartered credit unions. However, it is important to keep in mind that federal credit unions cover the majority of NCUA's operating expenses. Even with the current overhead transfer rate of 71.8 percent, federal credit unions are still covering 66.4 percent of NCUA's operating expenses for 2015. That's because federal credit unions hold a majority of insured shares. Thus, federal credit unions pay for a majority of the insurance activities covered by the overhead transfer rate, and also for all non-insurance activities through an annual operating fee assessed by NCUA.

The table below compares the contributions of federal and state credit unions:

Portion of Operating Budget covered by	Federal Credit Unions	Federally Insured, State-Chartered Credit Unions
Overhead Transfer Rate x Percent of Insured Shares	38.2% (71.8% x 53.2%)	33.6% (71.8% x 46.8%)
Federal Credit Union Operating Fee	28.2%	0.0%
Total	66.4%	33.6%

As previously stated, the current overhead transfer rate methodology has been in use since 2003. NCUA has committed to publishing the methodology for comment in January 2016 and considered alongside the federal credit union operating fee methodology and NCUA's next proposed strategic plan. This will permit stakeholders to provide input into the budget process from all angles. NCUA will carefully consider and respond to all comments received as part of this process.

Finally, there is no evidence the overhead transfer rate or underlying methodology influence charter conversions from a state charter to a federal charter.

7. ***The GAO studied NCUA's use of the OTR in 1991, and again in 2003, and noted concerns regarding NCUA's process for determining the rate. Among other things, GAO noted "The lack of a clear separation of the insurance and supervisory functions," within NCUA. What steps has the agency taken to address those concerns and ensure a clear distinction between supervisory and insurance-related activity?***

Actually, the 1991 GAO report studied whether supervision of the Share Insurance Fund should be separated from the other functions of the NCUA Board. The report concludes it was not necessary to separate the Share Insurance Fund from NCUA. The GAO report states, "Separation of [Share Insurance Fund] from NCUA's chartering, regulation, and supervision responsibilities would not, based on these analyses, by itself guarantee either strong supervision or insurance fund health. And such a move could result in additional and duplicative oversight costs. In addition, it can be argued that a regulator/supervisor without insurance responsibility has less incentive to concern itself with insurance costs, should an institution fail."

GAO did recommend that NCUA establish separate positions for a Director of Supervision and a Director of Insurance, each reporting separately to the Board. GAO indicated this recommendation was to ensure discussion of trade-offs, such as weakened supervision over timely insurance action, would be elevated to the Board level "to ensure that [Share Insurance Fund] will, in the future, continue to be protected." GAO addresses this as a general issue, not specifically related to the overhead transfer rate. It should be noted GAO did not repeat this recommendation in its 2003 review, but did suggest further improvements to the OTR process.

NCUA's supervisory and insurance functions are inherently complementary and inextricably linked. NCUA's mission is to protect the safety and soundness of the credit union system, as well as enforce applicable laws and regulations to protect consumers and the integrity of the financial system. Ensuring the safety and soundness of the credit union system is the primary means by which NCUA protects the Share Insurance Fund and, ultimately, the taxpayers.

NCUA has established a reasonable measure of separation of its supervisory and chartering functions. NCUA created a separate Office of Consumer Protection responsible for chartering credit unions, administering fields of membership, and providing direction and leadership for consumer protection laws. NCUA's Office of Examination and Insurance provides overall direction and leadership for the agency's safety and soundness examination program. The director of the Office of Examination and Insurance also serves as the president of the Share Insurance Fund. In the capacity as president of the fund, this position reports directly to the NCUA Board.

Also, examination and supervision of federally chartered credit unions and federally insured, state-chartered credit unions is conducted by NCUA's five regional offices and the Office of National Examinations and Supervision. Each field director reports to the agency's executive director. This structure provides for a reasonable measure of checks and balances on the different roles within NCUA, and the president of the Share Insurance Fund has direct access to the NCUA Board for any matters that could unduly compromise the fund's health.

As it pertains to the overhead transfer rate, NCUA has explicitly identified insurance-related functions. As noted in our response to the previous question, NCUA has defined insurance-related functions and conducted a regulation-by-regulation review in 2012 to make the allocation of time and expenditures more explicit. In 2013, NCUA again contracted with PricewaterhouseCoopers to independently review the refinements. The 2013 report found the agency's 2012 refinements more clearly describe insurance and non-insurance related activities.

8. ***You testified that the NCUA Office of General Counsel directed the PwC's report to be redacted before it was posted. How is it possible that you were not aware of this until almost 4 years later?***

FOIA requests are processed by staff in the Office of General Counsel. When the agency receives a FOIA request, FOIA staff consult with the office responsible for the subject records to identify those records that are responsive to the request. Staff then determine whether the records or any portions are releasable or exempt, in whole or in part, from release.

Generally, NCUA Board members do not receive notice or copies of FOIA requests or FOIA determinations unless the subject records specifically pertain to the Board members or unless other aspects of the FOIA request concern sensitive matters for the agency. As noted during my answer to your question during the hearing, I only became aware of the redacted report in my preparations for the hearing. At my instruction, an unredacted version of the report was posted on the NCUA website the following day.

9. ***In light of the problems surrounding the treatment of the PwC report, the Subcommittee is also concerned how authority is delegated to staff from the NCUA Board. Please explain this process and what safeguards the Board and the agency have in place to ensure the Board remains in charge of the agency, as provided for in the Federal Credit Union Act.***

Management of the agency is vested in the NCUA Board, as provided in the Federal Credit Union Act.[4] The act also specifically authorizes and empowers the Board to "delegate to any person or persons...the performance and discharge of any authority, power, or function vested in [the NCUA Board] by this chapter."[5]

For the sake of administrative efficiency, the NCUA Board has exercised this statutory power through a comprehensive set of written delegations by which operational decisions and the implementation of policy may be accomplished at levels within the agency consistent with supervisory control and sound management. All delegations are approved by the NCUA Board and are subject to amendment or cancellation at the direction of the NCUA Board. Any authority that has not been delegated is retained by the NCUA Board.

10. ***The agency's legal analysis that supported the redaction of the PwC's report before it was posted raises questions about other NCUA legal interpretations, such as whether the agency can require supervisory information directly from Credit Union Service Organizations (CUSOs), which it has no statutory authority to regulate. Please provide the agency's legal analysis on the issue of the regulation of CUSOs.***

As background, the NCUA Board unanimously approved the final CUSO Risk Transparency rule in November 2013.[6] The final rule was published in the *Federal Register* along with an explanation of the need for the rule and a response to the comments received on the rule.[7] The preamble to this rulemaking acknowledges that NCUA does not have direct statutory and regulatory authority over the operations of CUSOs.

However, NCUA does have the authority to regulate federal credit unions' lending and investment in CUSOs.[8] NCUA has regulated this lending and investment authority in the CUSO rule since 1979, when this statutory provision was implemented through the issuance of the first CUSO regulation.[9] NCUA's Office of General Counsel believes the proposed reporting

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[4] See 12 U.S.C. 1752a(d).
[5] See 12 U.S.C. 1766(d).
[6] See 12 C.F.R. 712.
[7] See http://www.ncua.gov/Legal/Documents/Regulations/FIR20131121ServiceOrganizations.pdf.
[8] See 12 U.S.C. 1757(7)(I), 1757(5)(D).
[9] See 44 FR 12401 (March 7, 1979).

requirement is both historically and legally consistent with NCUA's statutory authority to regulate this lending and investment authority.

Moreover, Title II of the Federal Credit Union Act provides the NCUA Board with the broad authority to insure members' accounts and administer the Share Insurance Fund. The title also allows the NCUA Board to prescribe regulations for federally insured credit unions that are necessary to carry out that purpose.[10] All federally insured credit unions, through their application for insurance, have agreed to comply with those regulations.

The lack of information on CUSOs limits NCUA's ability to conduct offsite monitoring and assess any emergent risks to the Share Insurance Fund posed by CUSO operations. To protect the Share Insurance Fund from any such risks, it is necessary and within NCUA's authority to implement regulations that require credit unions to enter into agreements with CUSOs requiring CUSOs to submit reports directly to NCUA and the appropriate state regulators, if applicable.

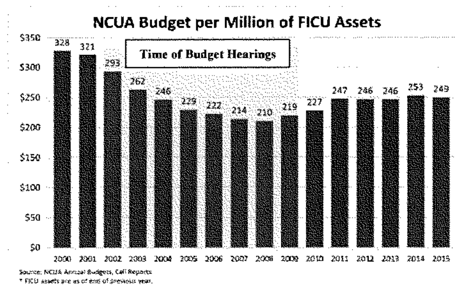
NCUA maintains legal opinions between the NCUA Board and its Office of General Counsel are privileged and confidential communications, as is the practice and norm between attorneys and their clients and in government, and thus does not release such internal legal opinions publicly. These documents, therefore, are not included in this response. However, NCUA delineates the applicable governing legal authority clearly in the preamble of rules we propose and finalize.

NCUA attorneys are also willing to brief any Subcommittee members or staff on the agency's legal authority related to the CUSO rule at your request and convenience.

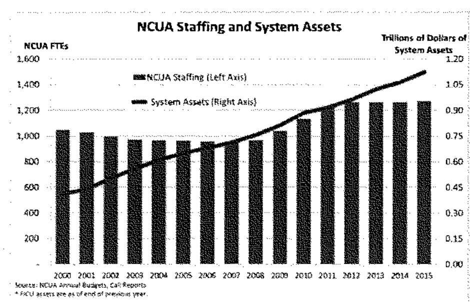
11. ***During the hearing, you testified that you feared a budget hearing would negatively influence NCUA. Please explain how a review of the agency's budget on the record with notice and comment would influence the agency in such a manner. Are you concerned that board members would fall prey to unscrupulous influence? How would the influence factor regarding the budget be different from receiving input under a notice and comment process on other material issues? Isn't more information and input consistent with our democratic system of government?***

My concerns about the legislation to mandate budget hearings arise from experience. When NCUA held public budget briefings from 2001 to 2008 during the run-up to the financial crisis, credit union trade groups consistently advocated for cuts to NCUA's budget and exam hours. Subsequent to these hearings, the NCUA Board approved budgets that remained essentially flat. As shown in the chart below, these budgets did not keep an appropriate pace with growing credit union assets, risks, product and service complexity, industry interconnectedness, and concentration.

[10] See 12 U.S.C. 1781(b)(9), 1789(11).



As illustrated in the chart below, during the seven years leading up to the financial crisis, NCUA also cut a total of 91 staff positions—even though credit union assets had increased by 73 percent. During this same period, NCUA's budget as a percentage of credit union assets declined by 35 percent. NCUA was under-staffed and under-resourced.



This critical pre-crisis staff reduction hurt the ability of NCUA to respond initially to the financial crisis. As a result, substantial staff increases were necessary for NCUA to rebuild the examination and supervision program necessary to ensure the safety and soundness of credit unions going forward. In my view, regulatory budgets should be designed to be counter-cyclical, precisely so budget increases are not necessarily imposed on regulated entities during times when they are experiencing economic stress and can least afford additional regulatory costs.

As to how future NCUA Boards might react under pressure at public hearings to reduce NCUA's budget and staffing, I simply cannot predict. But policymakers concerned about ensuring safety and soundness should consider the lessons of the past when trade groups had access to pre-decisional budget information. Rather than repeat history, NCUA needs to have the capability to detect and resolve problems before those problems cause credit union failures.

The Government Accountability Office, as well as NCUA's Inspector General, both found in their own reports that NCUA could have done a better job of earlier detection and resolving problems in credit unions leading up to and through the crisis—a shortcoming which I have worked hard to rectify since becoming Chairman in 2009. Part of that is hiring and retaining enough experienced, well-trained examiners, which runs contrary to the budget-cutting and examination reductions consistently promoted by trade groups.

In the interests of transparency and accountability, NCUA has made over 80 documents related to our budgets and budget processes available on our website to the public. All of this public budget information and transparency affords stakeholders ample opportunities to express their views about NCUA's current and future budgets. Indeed, each year prior to the budget vote, the Board receives letters and visits from trade groups urging NCUA to reduce examinations and flatten the budget.

In my view, Congress wisely designated NCUA as an independent agency, along with other federal financial depository regulators, such as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. Congress acted, in part, to insulate the agencies from political pressures from the financial institutions we regulate on policy and budget matters.

I am still concerned that there is not a sufficient, well-thought-out public policy rationale to explain why NCUA alone is being singled out among all federal financial institutions regulators to be compelled to conduct public budget hearings and publish our budget each year for comment. Compared to our peer agencies, NCUA is clearly the most transparent in terms of the information we release about our budget and the budget process.

Looking forward, NCUA Vice Chairman Rick Metsger recently publicly suggested that the NCUA Board should institute the practice of two-year budget cycles. This would represent a return to normal for NCUA, as the Board under four previous chairmen approved two-year budgets from 1996 to 2009.

Now that the aftermath of the financial crisis is behind us, and we can project upcoming budget needs with more accuracy, I have asked staff to once again present a two-year budget. I agree a two-year budget for 2016 and 2017 would provide greater transparency to the public and greater certainty to stakeholders.

12. ***Chairman Matz, you said during the hearing that an independent regulator is not answerable to the entities it regulates and it is not good government to have people who are regulated participate in the process of the regulator. Please explain to the Subcommittee how you view your role in light of the U.S. Constitution, the Administrative Procedure Act, directives from the Administration on openness in government, the Federal Credit Union Act and bipartisan concerns raised by the Subcommittee during the hearing.***

Actually, what I said word-for-word was: "I do not think it is good government to have the people who are regulated trying to participate in the budget-making process of the regulator, the regulator who determines how many exam hours it needs and where those hours are allocated."

To me, by design, an effective independent regulator must exercise independent judgment in pursuing industry safety and soundness. It should not be overly influenced by external political concerns or pressures that may reflect narrower or self-interested perspectives, especially when setting a budget designed to protect federally insured financial institutions and more than 101 million Americans who belong to federally insured credit unions.

When a regulator of financial institutions becomes too close to the entities it regulates, the results can be costly. The savings and loan industry's influence over its regulator and insurer in the early 1980s exacerbated the savings and loan crisis and resulted in catastrophic systemic losses. Congress subsequently responded by putting in place safeguards to protect the independence of financial institutions regulators.

Please keep in mind that my answer to this question focuses on regulated entities' influence over regulators' budgets, staffing, and examination hours. On regulatory policy issues, we constantly welcome input and public comments on initiatives to enhance credit union operations and remove regulatory burdens.

In September 2011, I launched NCUA's Regulatory Modernization Initiative to update regulations that limited credit unions' flexibility and growth, without jeopardizing safety and soundness. Supporting this initiative, I've held dozens of in-person and online town-hall meetings to solicit feedback from stakeholders. These events have identified regulatory relief opportunities on which the agency has since acted.

During its first four years, the Regulatory Modernization Initiative has resulted in 20 actions to cut red tape and provide lasting benefits to credit unions of all sizes. Specifically, NCUA has worked to ease 12 regulations, providing regulatory relief to thousands of credit unions. NCUA also streamlined four processes and issued four legal opinions providing further flexibility in credit union operations. Many of these regulatory improvements resulted from conversations I've had with credit union officials and volunteer board members.

I also welcome the comments the agency receives from stakeholders during rulemakings. These comments help the agency improve proposed rules and identify unintended consequences.

In the end, NCUA and stakeholders should be working toward the same goals: to protect the safety and soundness of America's credit unions and to safeguard their accountholders who are federally insured by NCUA.

Attachment

- Letter to the National Association of State Credit Union Supervisors from NCUA General Counsel Michael J. McKenna (August 18, 2015)

National Credit Union Administration

August 18, 2015

SENT BY CERTIFIED MAIL

Ms. Lucy Ito
President and CEO
National Association of State Chartered Credit Unions
1655 North Fort Myer Drive, Suite 650
Arlington, VA 22209

Dear Ms. Ito:

Re: Legal Analysis of Overhead Transfer Rate

This opinion letter discusses the legal analysis of NCUA's Office of General Counsel on whether notice and comment rulemaking processes under the Administrative Procedure Act ("APA") are required for NCUA's Overhead Transfer Rate ("OTR") methodologies and determinations. In addition, to fully respond to recent claims that NCUA is not APA compliant with respect to the OTR, this opinion reviews the arguments in a document titled "*Legal Analysis Of The Administrative Procedure Used By The National Credit Union Administration To Adopt The Overhead Transfer Rate*," dated June 17, 2015 and produced by the law firm Schwartz & Ballen LLP as a "*Report to the National Association of State Credit Union Supervisors*" (the "Report"). The Report, enclosed as Exhibit A to this letter, contends that the OTR is a rule under the APA that requires notice and comment rulemaking procedures because no APA exemption applies. The Report further alleges, among other things, that the OTR is a major rule for purposes of the APA.

Consistent with prior legal analyses, we conclude that the APA does not require either OTR calculations or processes to be developed under APA notice and comment requirements. Further, nothing in the Report provides a sound legal basis for requiring NCUA to change its long-held position. Finally, contrary to the Report's conclusion, we do not believe the OTR process could be designated a major rule under the Congressional Review Act ("CRA"), even if APA notice and comment procedures applied.

The conclusions and assertions in this opinion are based on public information that is available to NASCUS and any other interested parties. The cited statutes and cases, and the circumstances to which they apply, are a matter of public record. By providing this opinion to the public, NCUA does not waive the protections of 12 C.F.R. § 792.11(a)(5) or the general application of attorney/client privilege or attorney work product doctrines for any other legal analyses of the OTR or any other matter.

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300

Ms. Lucy Ito
August 18, 2015
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Further, application of privilege doctrines or other confidentiality protections do not make NCUA's legal conclusions intentionally secretive or unjustified, even if they are the subject of disagreement among reasonable persons. The job of the Office of General Counsel is not only to advocate, but to determine the relative strength of a legal position, in part by objectively examining and reviewing counterarguments. With respect to the APA, which is not specific to NCUA in its application and which is an intensely scrutinized and evaluated statute, the range of reasonable arguments on disputed issues is relatively accessible.

It appears to us that the Report was commissioned for advocacy, rather than advisory purposes, and we believe it should be viewed in that context. The Report's advocacy posture is demonstrated by, among other things, (i) repeated reference to events and circumstances that bear on policy, rather than legal, determinations; (ii) failure to discuss in any way the Federal Credit Union Act's ("FCU Act") discretionary language, which is the foundation for OTR processes; (iii) failure to accurately characterize the "major rule" concept; (iv) lack of transparency with respect to the citation of cases relying on tests and principles that have since been rejected; and (v) failure to acknowledge in any way the complications in applying APA standards and exemptions, which are chronicled by many of the courts and scholars engaged in such processes.[1]

Our conclusion that notice and comment processes are not required does not lead to the conclusion that they may not be used as a legal matter. The NCUA Board Chair's recent commitment to formally solicit comments every three years demonstrates an alternative approach within the range of legally permissible methods by which NCUA can engage in OTR processes. Further, NCUA is able to receive and consider public input on its processes at any time, not only through formal solicitations or in the APA rulemaking context. These formal and informal interactions with parties affected by NCUA activities have occurred throughout the agency's history.

I. **Background**

NCUA charters and regulates federal credit unions and regulates and supervises state-chartered credit unions that have their shares insured through the National Credit Union Share Insurance Fund ("NCUSIF") in coordination with State Supervisory Authorities ("SSAs"). To cover expenses related to its tasks, the NCUA Board adopts an operating budget in the fall of each year (the "Operating Budget"). The FCU Act provides two primary sources to fund the Operating Budget: (1) requisitions from the NCUSIF; and (2) operating fees charged against federal credit

[1] *See, e.g.*, *Cmty. Nutrition Inst. v. Young*, 818 F.2d 943, 946 (D.C. Cir. 1987) ("The distinction between legislative rules and interpretative rules or policy statements has been described at various times as 'tenuous,' *Chisholm v. FCC*, 538 F.2d 349, 393 (D.C. Cir.), *cert. denied*, 429 U.S. 890, 97 S. Ct. 247, 50 L. Ed. 2d 173 (1976), 'fuzzy,' *Pacific Gas & Electric Co. v.* FPC, 506 F.2d 33, 38 (D.C. Cir. 1974), 'blurred,' Saunders, *Interpretative Rules With Legislative Effect: An Analysis and a Proposal For Public Participation*, 1986 Duke L.J. 346, 352, and, perhaps most picturesquely, 'enshrouded in considerable smog.' *Noel v. Chapman*, 508 F.2d 1023, 1030 (2d Cir.), *cert. denied*, 423 U.S. 824, 96 S. Ct. 37, 46 L. Ed. 2d 40 (1975), *quoted in American Bus Association v. United States*, 627 F.2d 525, 529 (D.C. Cir. 1980).").

unions. The Board uses an allocation formula, the OTR, to determine the amount of the Operating Budget that it will procure from the NCUSIF.

NCUA has never used notice and comment rulemaking to establish either an individual determination of the OTR or the general methodology used to calculate the OTR. The OTR has, however, been explained, discussed, and reviewed in various public records, including in Board Action Memorandums related to budget matters and other documents available on NCUA's Web site.[2] Since the OTR's inception, NCUA has taken the position that the OTR is not a legislative rule under the APA and is exempt from notice and comment rulemaking processes.

II. <u>The Administrative Procedure Act</u>

Under the APA, a rule means

> the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services or allowances therefor or of valuations, costs, or accounting, or practices bearing on any of the foregoing . . . .[3]

The APA's definition of a rule is very broad and applies to "nearly every statement an agency may make."[4] However, determining whether the APA notice and comment requirements apply to a particular agency action or rule is a separate inquiry. Statutory exemptions from APA notice and comment requirements include matters "relating to agency management or personnel or to public property, loans, grants, benefits, or contracts" and "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice . . . ."[5]

The United States Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") "has generally referred to the category of rules to which the notice and comment requirements apply as 'legislative rules' or, sometimes, 'substantive rules'", as opposed to "interpretive rules."[6] "A rule is legislative if it supplements a statute, adopts a new position inconsistent with existing regulations, or otherwise effects a substantive change in existing law or policy."[7] Rules are interpretative, and exempt from notice and comment requirements, if they "clarify a statutory or

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[2] Materials related to the OTR that appear on NCUA's Web site can be found at the following Web address: http://www.ncua.gov/about/Pages/budget.aspx.

[3] § 551(4).

[4] *Batterton v. Marshall*, 648 F.2d 694, 700 (D.C. Cir. 1980).

[5] 5 U.S.C. § 553(a)(2) & (b)(3)(A).

[6] *Mendoza v. Perez*, 754 F.3d 1002, 1021 (D.C. Cir. 2014) (citation omitted).

[7] *Id. But see Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1203, 191 L. Ed. 2d 186 (2015) (Holding that, without more, an agency is not required to "use the APA's notice-and-comment procedures when it wishes to issue a new interpretation of a regulation that deviates significantly from [an interpretation] the agency has previously adopted.").

regulatory term, remind parties of existing statutory or regulatory duties, or 'merely track[ ]' preexisting requirements and explain something the statute or regulation already required."[8] A substantial impact imposed by an interpretive rule "does not transform it into a legislative rule" requiring notice and comment.[9]

"An agency action that merely explains how the agency will enforce a statute or regulation—in other words, how it will exercise its broad enforcement discretion or permitting discretion under some extant statute or rule—is a general statement of policy" that is exempt from notice and comment rulemaking.[10] "The most important factor [in making the legislative/interpretive/policy determination] concerns the actual legal effect (or lack thereof) of the agency action in question on regulated entities."[11] Courts also consider how an agency characterizes an action, including any statements about intent to legally bind regulated entities.[12]

III. NCUA's Analysis

Under the above authority, no part of the OTR process requires notice and comment rulemaking. First, the OTR tracks and interprets discretionary statutory language that makes the NCUSIF available to pay expenses the Board determines to be proper under Title II of the FCU Act. As such, the OTR is an interpretive rule or general statement of policy. Second, the OTR is part of NCUA's budget processes, inextricable from agency management, procedure, and practice.

i) The OTR is an Interpretive Rule

There is no express provision in the FCU Act that requires a rulemaking to establish when or how the Board will requisition the NCUSIF to pay administrative expenses. In fact, the FCU Act's language on this point is highly deferential, qualified by phrases like "as [the Board] may determine to be proper"[13] and "as [the Board] may deem necessary or appropriate".[14] Under this language, NCUA's OTR methodology and calculation is a means of explaining a function committed to agency discretion by the FCU Act.

In *New Jersey Department of Human Services v. U.S. Department of Health & Human Services*,[15] the United States District Court for the District of New Jersey addressed whether the Health Care Financing Administration's ("HCFA") changes to a manual governing federal reimbursement rates for expenses incurred by states in administering Medicaid were legislative or interpretive rules. The court applied a test articulated by the D.C. Circuit in *Community*

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[8] *Mendoza*, 754 F.3d at 1021.
[9] *Cent. Texas Tel. Co-op., Inc. v. F.C.C.*, 402 F.3d 205, 214 (D.C. Cir. 2005) (citing *Am. Hosp. Ass'n v. Bowen*, 834 F.2d 1037, 1046 (D.C. Cir. 1987) (quoting *Am. Postal Workers Union v. United States Postal Serv.*, 707 F.2d 548, 560 (D.C. Cir. 1983))).
[10] *Nat'l Min. Ass'n v. McCarthy*, 758 F.3d 243, 252 (D.C. Cir. 2014).
[11] *Id.*
[12] *Id.*
[13] 12 U.S.C. §1783(a).
[14] § 1766(i).
[15] 748 F. Supp. 1120 (D.N.J. 1990).

Nutrition Institute v. Young,[16] which "provided two criteria for assisting in the determination of whether a rule is legislative or interpretative: (1) whether the rule establishes a binding norm, and (2) whether the rule allows the agency and its decision makers leave to exercise their discretion."[17] "If the rule acts prospectively and without binding effect, . . . it is said to be interpretative."[18]

The court found that HCFA's changes to the manual described rates at which certain costs were reimbursable but did not bind the State of New Jersey and did not "oblige the State to assume any obligations or duties."[19] Further, the court determined the manual acted prospectively and permitted the HCFA to exercise its discretion.[20] The court noted that the direct reduction in reimbursement rates to states did not transform the manual into a substantive rule.[21]

Similarly, the OTR has no direct binding legal effect on insured credit unions. It does not impose or require credit unions to take on new duties. There is no compliance component to the OTR and NCUA cannot use it as the basis for an enforcement action. In addition, documents describing OTR methodology permit NCUA employees and officers to exercise their discretion. The OTR process allows for elements of judgment in connection with what examination procedures to perform and in guidance on how examiners record their time.[22] Allocation factors applied to the cost of NCUA resources and programs are reviewed annually, demonstrating NCUA's view that OTR processes are not subject to notice and comment requirements.[23]

With respect to substantial impact or legal effect, the correlation between the OTR and NCUSIF assessments or distributions is tenuous and diluted. In addition to the OTR, whether a FICU experiences an assessment or distribution is affected by (i) the amount of statutorily required insurance payments from the NCUSIF,[24] (ii) interest rates on NCUSIF investments,[25] (iii) special assistance payments from the NCUSIF,[26] (iv) adjustments to the NCUSIF's normal operating level (which the Board sets anywhere from 1.2 percent to 1.5 percent),[27] (v) the NCUSIF's available assets ratio,[28] (vi) the timing of assessments in the event of a restoration plan (which can extend out to eight years or more),[29] and (vii) NCUSIF borrowings from the United States

[16] 818 F.2d 943 (D.C. Cir. 1987).
[17] *N.J. Dep't of Human Servs.*, 748 F. Supp. at 1127.
[18] *Id.* (citing *Cmty. Nutrition Inst.*, 818 F.2d at 946 n.4).
[19] *Id.* at 1127-28.
[20] *Id.* at 1128.
[21] *Id.* at 1127.
[22] *See, e.g.*, NCUA Office of Examination and Insurance, *Introduction to the Overhead Transfer Rate*, http://www.ncua.gov/about/Documents/Budget/Misc%20Documents/IntrotoOTRPresentation_10_2014%20Final.pdf (last visited Apr. 22, 2015 and on file with author) *&* Board Action Memorandum on Overhead Transfer Rate 2015, p. 2 (Nov. 20, 2014), http://www.ncua.gov/about/Documents/Agenda%20Items/AG20141120Item4.pdf.
[23] *See, e.g.*, Board Action Memorandum, *supra* note 22, at 1.
[24] 12 U.S.C. § 1787(d).
[25] § 1783(c).
[26] § 1788.
[27] § 1782(h)(4).
[28] § 1782(h)(1).
[29] § 1782(c)(2)(D).

Treasury ("Treasury") or the Central Liquidity Facility ("CLF").[30] A required assessment or distribution to insured credit unions is triggered only if the NCUSIF's equity ratio deviates outside of the statutorily prescribed range (further subject to variables (iv), (v), (vi), and (vii), above). The OTR has a less significant and more indirect effect on third parties or regulated entities than the HCFA's guidelines had on Medicaid reimbursements.

ii) The OTR is a General Statement of Policy

While a distinction between interpretive rules and policy statements is often ignored, the OTR also meets the characteristics of a general statement of policy. General statements of policy are, according to the Attorney General's APA Manual, "statements issued by an agency to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power."[31] The D.C. Circuit has explained that an agency policy statement "merely represents an agency position with respect to how it will treat—typically enforce—the governing legal norm."[32] The statement "simply lets the public know its current enforcement or adjudicatory approach" and "[t]he agency retains the discretion and the authority to change its position—even abruptly—in any specific case because a change in its policy does not affect the legal norm."[33]

In *National Mining Association v. McCarthy*,[34] the D.C. Circuit found that the Environmental Protection Agency's ("EPA") Final Guidance that instructed EPA staff to recommend limitations on mining projects amounted to a statement of policy. According to the plaintiffs, the Final Guidance gave "permit applicants (and state permitting authorities) [ ] no choice when faced with EPA 'recommendations' except to fold."[35] Despite this alleged effect, the D.C. Circuit reasoned as follows in support of its holding:

> The Final Guidance does not tell regulated parties what they must do or may not do in order to avoid liability. The Final Guidance imposes no obligations or prohibitions on regulated entities. State permitting authorities "are free to ignore it." The Final Guidance may not be the basis for an enforcement action against a regulated entity. Moreover, the Final Guidance may not be relied on by EPA as a defense in a proceeding challenging the denial of a permit. And the Final Guidance does not impose any requirements in order to obtain a permit or license. As a matter of law, state permitting authorities and permit applicants may ignore EPA's Final Guidance without facing any legal consequences.[36]

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[30] § 1783(d) & (f).
[31] Attorney General's Manual on the Administrative Procedure Act 30 n.3 (1947).
[32] *Syncor Int'l Corp. v. Shalala*, 127 F.3d 90, 94 (D.C. Cir. 1997).
[33] *Id.*
[34] 758 F.3d 243, 252 (D.C. Cir. 2014).
[35] *Id.* at 253.
[36] *Id.* (citations omitted).

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The court's view of the Final Guidance in *McCarthy* aligns remarkably with the effect and implications of the OTR with respect to FICUs. In fact, one could substitute the term "OTR" for "Final Guidance" in the court's language above and produce an apt description of the OTR.

As noted above, other than for statutorily required insurance payments, the FCU Act sets forth a discretionary standard for NCUSIF requisitions. The OTR bears out this discretion in its key components, such as the examiner time survey, filled out by principal examiners selected on a rotating basis. In connection with the time survey, NCUA has stated expressly that it created a rule matrix to assist examiners in properly classifying their time as related to regulatory or insurance matters.[37] Further, NCUA has made adjustments to the matrix and reviews allocation factors annually, demonstrating its view that the OTR is a policy, subject to alteration outside of rulemaking procedures.[38] This approach and language is consistent with the APA's and the D.C. Circuit's explanation of general policy statements.

iii) The OTR is a Matter of Agency Management and Agency Organization, Procedure, or Practice

The APA expressly exempts from notice and comment requirements matters "relating to agency management or personnel or to public property, loans, grants, benefits, or contracts" and rules of agency organization, procedure, or practice.[39] The D.C. Circuit has construed the exemption for matters relating to agency management as cutting a "wide swath."[40] Within these exemptions, settled law provides NCUA with discretion to set its budget without a rulemaking.[41] The OTR is a component of NCUA budget processes, allocating expenditures to a permissible source.

In *Lincoln v. Vigil*,[42] the United States Supreme Court noted that "decisions to expend otherwise unrestricted funds are not, without more, subject to the notice-and-comment requirements of § 553." Further, distinctions between the purpose and function of various regulations and how resources are allocated to their oversight involves "'a complicated balancing of a number of factors which are peculiarly within [an agency's] expertise': whether its 'resources are best spent' on one program or another; whether it 'is likely to succeed' in fulfilling its statutory mandate; whether a particular program 'best fits the agency's overall policies'; and, 'indeed, whether the agency has enough resources' to fund a program 'at all.'"[43] Once again, these circumstances apply to the OTR.

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[37] An example of this matrix is available on NCUA's Web site at the following address: http://www.ncua.gov/about/Documents/Budget/2013/2013ETSAnalysis.pdf.
[38] *See* Introduction to the Overhead Transfer Rate, *supra* note 22, at 7 & Board Action Memorandum, *supra* note 22, at 2.
[39] 5 U.S.C. § 553(a)(2) & (b).
[40] *Humana of S. Carolina, Inc. v. Califano*, 590 F.2d 1070, 1082 (D.C. Cir. 1978).
[41] *Lincoln v. Vigil*, 508 U.S. 182, 198 (1993) ("[D]ecisions to expend otherwise unrestricted funds are not, without more, subject to the notice-and-comment requirements of § 553.").
[42] 508 U.S. at 198.
[43] *Id.* at 193.

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As a practical matter, the FCU Act in 12 U.S.C. § 1783(a) makes no material distinction between how the Board should requisition the NCUSIF for special assistance under § 1788 and for administrative and budget expenses. The FCU Act uses discretionary language with respect to both.[44] NCUA has no regulation governing requisitions for special assistance and would vigorously dispute that one is required. The OTR may be more amenable to APA regulatory processes, but this characteristic does not, in itself, impose APA notice and comment requirements.

IV. The Report

The following is a Section-by-Section analysis of the Report that NASCUS commissioned with respect to the OTR.

Section 1.

In this section, the Report discusses the history of the OTR and alleges that changes to NCUA's OTR methodology have resulted in increasing charges to the NCUSIF and reduced operating fees charged to federal credit unions. We note, and the Report agrees, that NCUA has used an allocation process for the OTR since the early 1970s without employing notice and comment processes. This practice is consistent with NCUA's long-held position and characterization of the OTR. An agency's characterization is relevant to a determination of whether notice and comment processes apply.[45]

Section I of the Report also cites a 1973 United States General Accounting Office ("GAO") report.[46] In this report, the GAO initially recommended that NCUA use a cost allocation process for funding its operations from the NCUSIF. Notably absent from this report is any recommendation from the GAO that NCUA use notice and comment rulemaking procedures to establish its resource allocation.

Section II.A.

In this Section, the Report discusses NCUA's implementation procedure for the OTR. The Report observes that NCUA has never formally requested comment by publishing a proposed OTR, OTR methodology, or changes to the OTR methodology in the *Federal Register*. This fact is consistent with NCUA's settled position that the APA does not require notice and comment processes for the OTR. An agency's characterization "is entitled to a significant degree of credence."[47]

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[44] With respect to administrative expenses, § 1783(a) uses the phrase "as [the Board] may determine to be proper." With respect to special assistance expenses, § 1788 uses "which the Board has determined," "in [the Board's] discretion," "in the opinion of the Board," "in the judgment of the Board," and "upon such terms and conditions as [the Board] may determine."

[45] *Nat'l Min. Ass'n*, 758 F.3d at 252.

[46] This GAO report can be viewed at the following Web address: http://gao.gov/assets/210/203181.pdf.

[47] *Cabais v. Egger*, 690 F.2d 234, 238 n.7 (D.C. Cir. 1982) (citing *British Caledonian Airways, Ltd. v. CAB*, 584 F.2d 982, 992 (D.C. Cir. 1978)).

The Report further alleges that NCUA has never provided a reasoned, comprehensive explanation of its OTR methodology. However, approximately 12 pages of the 31 page Report meticulously describe the history and evolution of NCUA's OTR and its processes, gleaned from public documents, studies, and reports. In any event, these contentions, which we believe multiple offices at NCUA would strenuously dispute, do not bear on whether notice and comment requirements apply under the APA. Similarly, the fact that the OTR has increased in recent years does not support the conclusion that notice and comment requirements apply.

We did not scrutinize the Report's assertions about the impact of the OTR on the competitive position of state-chartered credit unions. Unquestionably, the OTR has an impact on all insured credit unions, as do almost all actions NCUA undertakes. To the extent NASCUS relies on an impact to conclude that notice and comment processes are required, we disagree and the courts do as well. An impact, even substantial, "does not mean [an agency action] is subject to notice and comment if it is otherwise expressly exempt under the APA."[48]

In addition, although the Office of General Counsel is only tangentially involved in OTR processes, we view with great skepticism the statements in the Report that imply that NCUA is manipulating the OTR to favor federal charters.[49] We have never seen any evidence to support this assertion. In two evaluations, procured for objective, internal, advisory purposes with respect to policy, PricewaterhouseCoopers ("PwC") made the following observations:

1. "<u>Based on PwC's review, there was no reasonable basis to conclude that the OTR Methodology ex-ante and for reasons beyond the control of the credit unions, favours or disadvantages any one type of credit unions (i.e. federal versus state chartered) over another.</u>"[50]

2. "The NCUA rules and regulations matrix aligns consistently with the insurance and regulatory activities and provides a documented bases supporting the allocation of examiner time between insurance and regulatory activities."[51]

Further, we do not believe NASCUS' characterization of the immediacy or nature of the impact is accurate. As stated above, the OTR's impact through the NCUSIF is affected and diluted by a variety of factors, including (i) the amount of statutorily required insurance payments, (ii) interest rates on investments, (iii) special assistance payments, (iv) adjustments to the normal operating level, (v) the available assets ratio, (vi) the timing of assessments in the event of a restoration plan, and (vii) borrowings from the Treasury or the CLF. Other external factors

[48] *Id.* at 237.
[49] *See, e.g.*, p. 10 of the Report ("By increasing the OTR, the NCUA Board was able to shift a substantial portion of NCUA expenses to the NCUSIF, thereby enabling it to reduce FCU Operating Fees for 2014.").
[50] PricewaterhouseCoopers, *Overhead Transfer Rate Review* 39 (Jan. 20, 2011), http://www.ncua.gov/about/Documents/Budget/Misc%20Documents/2011PwCOTRReview.pdf (emphases in original) (on file with author).
[51] PricewaterhouseCoopers, *Analysis of Examination Time Survey (ETS) Modifications* 2 (Oct. 2, 2013), http://www.ncua.gov/about/Documents/Budget/2013/2013ETSAnalysis.pdf (on file with author).

would likely have a significantly more immediate and substantial impact on a credit union's competitive position.

The Report references the studies of the OTR completed by PwC in 2011 and 2013 (the "PwC Studies"). The PwC Studies are not legal analyses. Nor are they documents NCUA has relied upon as legal support for not subjecting the OTR to notice and comment processes. Further, although one of the PwC Studies (i) notes "dissatisfaction within the industry with respect to the NCUA's efforts to communicate and explain the OTR methodology"; and (ii) recommends "providing more visibility on how [NCUA] characterizes its activities . . . and possibly solicit[ing] feedback with regards to the reasonableness and accuracy of the classification," such an observation bears on policy determinations, not legal conclusions.

We appreciate that credit unions care about the OTR and its impact. That fact demonstrates the strength of the system and a healthy engagement in governmental processes. We do not, however, believe the OTR's impact or industry criticisms lead to the conclusion that notice and comment processes are required.

Section II.B.

In this Section, the Report generally asserts that the OTR methodology constitutes a "rule making" for purposes of the APA. As noted above, whether agency action is a rule and whether notice and comment procedures apply are separate questions. The Report goes on to allege that none of the exemptions NCUA analyzed above could apply. The Report notably fails to discuss the relevant language of the FCU Act or its discretionary prose.

a. *Cases*

The Report discusses three cases for their application of law to facts in support of its conclusions. First, the Report cites *Minard Run Oil Company v. United States*.[52] In *Minard*, the court found that a moratorium the United States Forest Service imposed on drilling represented "a 'sea change' in the Service's policy regarding mineral rights that directly prohibits mineral rights owners from engaging in new drilling, *under threat of criminal penalties*."[53] The court further observed that "[t]he burden imposed by the moratorium goes far beyond 'the expense and annoyance of litigation [that] is part of the social burden of living under government.'"[54] In contrast, the OTR does not prohibit activities or impose criminal penalties. Further, as discussed above, the effect of the OTR on regulated entities, including their competitive positions, is diluted and tempered by a variety of other circumstances.

To the extent *Minard* relied on what it described as "a 'sea change' in [ ] policy" to require notice and comment rulemaking, the Supreme Court's recent ruling in *Perez v. Mortgage*

[52] 670 F.3d 236 (3d Cir. 2011), *as amended* (Mar. 7, 2012).
[53] *Id.* at 248 (citation omitted) (emphasis added).
[54] *Id.*

Bankers Association[55] puts its validity in doubt. In *Perez*, the Court held unequivocally that, without more, an agency need not "use the APA's notice-and-comment procedures when it wishes to issue a new interpretation of a regulation that deviates significantly from [an interpretation] the agency has previously adopted."[56] Further, other circuits have rejected the "substantive adverse impact" test, which the *Minard* court also proffered as one of the principal bases for its finding.[57]

Second, the Report cites *Anderson v. Butz*,[58] which addressed the United States Department of Agriculture's practices for food stamps. Noted as relevant to the district court's decision in *Anderson* that APA notice and comment processes applied, the Department of Agriculture had previously waived a potentially applicable exemption to APA notice and comment rulemaking.[59] Further, the court found it "noteworthy that in the past the Secretary of Agriculture ha[d] followed the [APA's] notice and comment procedure in connection with changes or clarification in agency practice regarding food stamp allotments."[60]

With respect to the OTR, NCUA has not waived any exemptions, nor has it used notice and comment processes in the past. In contrast, NCUA has consistently taken the position that notice and comment processes are not required for the OTR. The judge in *Anderson* also opined that the Department of Agriculture's adjustment to how housing subsidies factored into food stamp determinations "substantially and directly affected" the rights of individuals outside the agency.[61] In NCUA's case, the OTR does not result in an immediate assessment or distribution to insured credit unions. Depending on a multitude of factors, OTR determinations might not affect an assessment or distribution for many years. Further, eight years after the district court's decision in *Anderson*, the United States Court of Appeals for the Ninth Circuit expressly rejected the "substantial impact test" on which the *Anderson* court principally relied.[62] The D.C. Circuit has also rejected this test as a basis for concluding that notice and comment processes are required.[63]

The principal case cited in the Report is *Credit Union National Association v. National Credit Union Administration*.[64] In this case, the United States District Court for the District of Columbia invalidated an NCUA interpretive ruling and policy statement that eliminated "unsecured creditor priority over [credit union] members and [the] NCUSIF" in involuntary liquidations.[65] The court concluded that the Board's intent to give operational meaning to the

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[55] 135 S. Ct. 1199, 191 L. Ed. 2d 186 (2015).
[56] 135 S. Ct. at 1203.
[57] *See Rivera v. Becerra*, 714 F.2d 887, 891 (9th Cir. 1983) *& Cent. Texas Tel. Co-op., Inc.*, 402 F.3d at 214 (citing *Cabais*, 690 F.2d at 237–38).
[58] 428 F. Supp. 245 (E.D. Cal. 1975)
[59] *Id.* at 249.
[60] *Id.* at 251.
[61] 428 F. Supp. at 250.
[62] *Rivera*, 714 F.2d at 891.
[63] *Cent. Texas Tel. Co-op., Inc.*, 402 F.3d at 214 (citing *Cabais*, 690 F.2d at 237–38).
[64] 573 F. Supp. 586 (D.D.C. 1983)
[65] *Id.* at 589.

FCU Act where it was silent on payout priorities was an effort to make new law.[66] However, unlike its relative silence on the payout priorities in involuntary liquidation,[67] the FCU Act specifically makes the NCUSIF available "upon requisition by the Board, *without fiscal year limitation*, for making payments of insurance . . . , for providing assistance and making expenditures under section 1788 . . . , and for such administrative expenses incurred in carrying out the purposes of [Title II of the Act] *as it may determine to be proper*."[68] The FCU Act expressly permits requisitions for NCUA operations and commits such requisitions, particularly for administrative expenses, to the Board's discretion. The Report provides no discussion of this FCU Act language.

In addition, *Credit Union National Association* does not address a matter related to NCUA's budget. With respect to the OTR, in addition to the exemption for interpretive rules and policy statements, APA exemptions related to agency organization, procedure, or practice and agency management apply. The court in *Credit Union National Association* did not address these exemptions. Finally, the court in *Credit Union National Association* again placed reliance on the "substantial impact test," the proper application of which the D.C. Circuit has now put in grave doubt.[69] To wit: **"But we rejected such a test for determining whether an agency pronouncement was a legislative rule or an interpretive rule. Because both types of rules may 'vitally affect private interests,' the 'substantial impact test has <u>no</u> utility in distinguishing between the two.'"**[70]

b. *The Good Cause Exemption*

The Report also discusses the "good cause" notice and comment exemption in Section II.B. To invoke it, an agency must incorporate into an issued rule a finding that the exemption applies, along with a brief statement supporting the reasons for asserting the exemption.[71] NCUA has not included a statement justifying the good cause exemption in documents related to the OTR. Such a statement would be inconsistent with the basis for NCUA's position that notice and comment processes do not apply and NCUA would not invoke this exemption.

c. *The Congressional Review Act: Major Rules*

Also in Section II.B., the Report contends that adoption of "the OTR should be deemed a major rule for purposes of the APA." As an initial matter, "major rule" designations apply under the CRA, not the APA. The CRA provides procedures by which Congress can take steps to prevent a rule from taking effect and, if designated as major, prevents a rule from going into effect until

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[66] *Id.* at 591-92.
[67] *See* 12 U.S.C. § 1787(b)(10), (11).
[68] § 1783(a) (emphasis added).
[69] *See Cent. Texas Tel. Co-op., Inc.*, 402 F.3d at 214 (citing *Cabais*, 690 F.2d at 237–38).
[70] *Id.* (emphases added).
[71] 5 U.S.C. § 553(B)(3)(B).

at least 60 days from specified dates.[72] "No determination, finding, action, or omission under [the CRA is] subject to judicial review."[73]

The CRA, in relevant part, defines a major rule as follows:

> any rule that the Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget [("OMB")] finds has resulted in or is likely to result in--
> (A) an annual effect on the economy of $100,000,000 or more;
> (B) a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or
> (C) significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic and export markets.[74]

Expressly excluded from the definition of "rule" is "any rule relating to agency management or personnel; or [ ] any rule of agency organization, procedure, or practice that does not substantially affect the rights or obligations of non-agency parties."[75] Since the OTR is a matter relating to agency management, we necessarily conclude that OMB would not designate it as a major rule under the CRA. In addition, the OTR is a rule of agency organization, procedure, or practice. As discussed above, the OTR has an indirect effect on credit unions, tempered by a variety of other contingent circumstances. Further, the OTR does not impose regulatory obligations on credit unions. NCUA can take no enforcement action based on the OTR.

The CRA also excludes from the definition of the term rule "any rule of particular applicability, including a rule that approves or prescribes for the future rates, wages, prices, services, or allowances therefor, corporate or financial structures, reorganizations, mergers, or acquisitions thereof, or accounting practices or disclosures bearing on any of the foregoing . . . ."[76] The Report's assertion, at page 17, that this language applies for purposes of the APA's definition of a rule is inconsistent with and undermines its later assertion that the OTR could be a major rule under the CRA.

<u>Section II.C.</u>

This Section of the Report states that "the [Office of the Comptroller of the Currency ("OCC") follows an APA notice and comment process both for the methodology it uses for determining [ ] assessments and fees, as well as for its actual assessments and fees." The Report also points out that "the [Federal Deposit Insurance Corporation ("FDIC")] utilizes an APA notice and comment process for its assessment methodology." The Report acknowledges that, "[w]hile the Federal Reserve Board [("FRB")]does not solicit public comment on the fees for Federal Reserve Bank

[72] 5 U.S.C. § 801.
[73] § 805.
[74] § 804(2).
[75] § 804(3)(B), (C).
[76] § 804(3)(A)

priced services, it does provide APA-compliant notice and comment on the methodology it uses to develop these fees." Finally, it points out that "the [FRB] followed an APA-compliant notice and comment process for imposing" new assessments under the Dodd Frank Act.

To the extent they bear at all on the legal analysis, we find the Report's analogies unpersuasive. The FDIC, FRB, and OCC each have complex assessment authorities that differ substantially from NCUA's.[77] The FRB and OCC do not administer insurance funds from which to requisition money for operations. To our knowledge, the FDIC funds its operating expenses entirely from the Deposit Insurance Fund ("DIF"). Further, the FDIC has complex risk-based assessment authority for the DIF, for which the Federal Deposit Insurance Act expressly requires implementing regulations. In contrast, the FCU Act severely restricts how NCUA can charge assessments and does not expressly require implementing regulations.

Under the FCU Act, each insured credit union must maintain a one percent deposit (adjusted annually or semi-annually depending on asset size) and pay assessments based on its insured shares.[78] The Board's discretion to charge insurance premiums is limited to circumstances when the NCUSIF's equity ratio is at least 1.2 percent and less than 1.3 percent.[79] No insurance premium may cause the equity ratio to exceed 1.3 percent.[80] Premiums are required if the ratio is below 1.2 percent.[81] Despite these statutory restrictions, NCUA has adopted regulations governing the methodology for insurance premiums and NCUSIF deposits that, among other things, establish (i) various definitions, (ii) an invoicing process, (iii) rules for conversion or termination of insurance, and (iv) administrative fees for late payment.[82]

Because of (i) material differences between funding and assessment authorities; and (ii) the case-specific analysis required under the APA, the practices of other regulators provide anecdotal authority, relevant, if at all, to policy rather than legal determinations. Comparing assessment regulations that apply direct assessments on regulated entities to NCUA's OTR is misleading. We found no evidence that the FDIC uses notice and comment processes for amounts that it transfers from the DIF for its operating expenses. Further, as recently as 2001, when the FDIC allocated budget expenses for specific work between the Savings Association Insurance Fund and the Bank Insurance Fund (the closest analogy we can discover to what NCUA does now with the OTR allocation), the FDIC did not treat its allocation as a rulemaking subject to notice and comment requirements.

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[77] For FDIC provisions, see 12 U.S.C. § 1817(b) and 12 C.F.R. Part 327. For OCC provisions, see 12 U.S.C. §§ 16; 196; 481; 482 and 12 C.F.R. Part 8. For FRB provisions, see 12 U.S.C. §§ 243; 244; 248; 326; 338; 467; 483 and 12 C.F.R. Part 246.
[78] 12 U.S.C. §1782(c).
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] 12 C.F.R. § 741.4

In any event, NCUA is not privy to the APA legal analyses of other regulators. Nor do we need to be. Under a case-specific analysis of requirements that apply to OTR circumstances, formal notice and comment processes are not required.

Section II.D.

In Section II.D., the Report cites portions of a 2003 GAO report that "raised questions about NCUA's process for determining the transfer rate."[83] Once again, this GAO report does not assert that any aspect of the OTR is subject to notice and comment procedures under the APA. Nor does it recommend that NCUA use notice and comment processes to establish the OTR. Further, although this report notes that certain state officials "expressed concern over NCUA's process for developing its overhead transfer rate, which they claimed was not transparent," the GAO did not make an independent finding that the OTR process is not transparent. Although the report recommends that NCUA "continuously improve the process for and documentation of the overhead transfer rate," it does so in the context of NCUA's current processes.[84] This GAO report provides anecdotal evidence, relevant, if at all, to policy rather than legal determinations.

Section III.

The Report concludes that "adoption of the OTR [is] subject to notice and comment requirements." Therefore, the Report alleges, NCUA's established process for implementing the OTR violates the APA. Based on our review of the law and cases, set forth above, the Report does not provide a sound legal basis for requiring NCUA to change its long-held position that neither the OTR nor its methodology is subject to notice and comment requirements.

V. Conclusion

Consistent with our prior legal analysis of the issue, we conclude that the APA does not require either OTR calculations or processes to be developed under APA notice and comment procedures. Further, nothing in the Report provides a sound legal basis for requiring NCUA to change its position. The cases discussed in Section III of this opinion, including *Lincoln v. Vigil*;[85] *National Mining Association v. McCarthy*;[86] and *New Jersey Department of Human Services v. U.S. Department of Health & Human Services*,[87] among others, staunchly rebut the cases cited in the Report.

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[83] This GAO report can be viewed at the following Web address: http://www.gao.gov/new.items/d0491.pdf.
[84] *Id.* at 83.
[85] 508 U.S. 182 (1993).
[86] 758 F.3d 243 (D.C. Cir. 2014).
[87] 748 F. Supp. 1120 (D.N.J. 1990).

I hope this opinion letter clarifies NCUA's position on the permissible administrative procedure surrounding the OTR.

Sincerely,

Michael J. McKenna
General Counsel

GC/KST:BHS
SSIC 3000

Enclosure

Exhibit A

NASCUS REPORT

(See Attached)

Legal Analysis Of The Administrative Procedure Used By The National Credit Union Administration To Adopt The Overhead Transfer Rate

Report to the
National Association of State Credit Union Supervisors

Schwartz & Ballen LLP
1990 M Street N.W.
Washington D.C. 20036

June 17, 2015

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EXECUTIVE SUMMARY

Since 1971, the National Credit Union Administration ("NCUA" or "NCUA Board") has used the resources of the National Credit Union Share Insurance Fund ("NCUSIF") to cover the NCUA's annual "insurance-related" expenses. The percentage of annual expenses the NCUA Board uses to determine the amount it will take from the NCUSIF to cover the NCUA's annual expenses is referred to as the Overhead Transfer Rate (the "OTR"). The OTR percentage and the resulting dollar amount of NCUA total expenses covered by funds from the NCUSIF have increased significantly over time.

Primarily as a result of a change in OTR calculation methodology adopted by the NCUA Board for the 2014 OTR, the amount of NCUA expenses allocated to federally insured state-chartered credit unions ("FISCUs") through the OTR increased 40.1% from $67.0 million in 2013 to $93.9 million (budgeted) for 2015. This significant increase has reduced the likelihood that FISCUs and federal credit unions ("FCUs") (referred to collectively as "federally insured credit unions") will receive a rebate from the NCUSIF. Although increases in the OTR for 2014 and 2015 also increased the amount of NCUA expenses allocated to FCUs through the NCUSIF, such increases in the OTR directly and materially benefitted FCUs by reducing the amount the NCUA assessed FCUs for NCUA expenses (the "FCU Operating Fees"). By shifting a portion of FCUs' share of NCUA expenses to the NCUSIF, the OTR reduces out-of-pocket expenses incurred by FCUs. The resulting reduction in FCU Operating Fees provides a singular advantage to FCUs and adversely affects the competitive position of FISCUs relative to FCUs.

The NCUA Board has never published a proposed OTR in the *Federal Register* for public comment, nor has it ever requested in the *Federal Register* public comment on its methodology for calculating the OTR or any change to its methodology. The NCUA Board also has never provided a reasoned, comprehensive explanation of its OTR methodology, including how the activities it defines for this purpose as "insurance-related" are actually related to insurance, why it has changed its position over time as to what constitutes "insurance-related activities," why it chooses to makes an adjustment to the OTR rather than make a direct payment from the NCUSIF to the state supervisory authorities for their insurance-related supervision of FISCUs, nor has it provided an adequate explanation of the methodology it uses to determine this adjustment. In addition, we are not aware of any independent third party determination that the NCUA Board's OTR methodology complies with the Federal Credit Union Act ("FCUA") or other applicable law.

Our analysis concludes that the NCUA Board's adoption of the OTR constitutes a rule subject to the Administrative Procedure Act ("APA") notice and comment requirements. Based on applicable case law, including cases involving the NCUA Board, we do not believe that any of the exceptions provided in the APA to its notice and comment requirements apply to the OTR. Moreover, given its impact on federally insured credit unions generally and the adverse effect on the competitive position of FISCUs relative to FCUs, we believe the NCUA Board's adoption of the OTR should be deemed a major rule for purposes of the APA, subject to the additional requirements that the NCUA Board provide: (i) a statement of purpose providing the underlying reason for the rule; (ii) monetized or quantified costs and benefits or a qualitative discussion of them; and (iii) a discussion of the alternatives.

The fact that other federal banking agencies, the Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), and Federal Reserve Board, follow the APA notice and comment process for the methodology they employ in determining their assessments and fees and/or for the actual assessments and fees strongly supports the conclusion that the NCUA Board's adoption of the OTR constitutes a rule subject to the APA notice and comment requirements. Finally, the GAO has recognized there are concerns with the procedures utilized by the NCUA Board to determine the OTR.

For the foregoing reasons, we believe the process the NCUA Board uses to implement the OTR violates the APA.[1] As courts have recognized:

> Voiding the present regulations on what at first blush appears to be a technicality is not as pointless as it may seem. We believe that the 30-day notice rule serves an important interest, the right of the people to present their views to government agencies which increasingly permeate their lives. The interchange of ideas between the government and its citizenry provides a broader base for intelligent decision-making and promotes greater responsiveness to the needs of the people, especially in cases such as this where Congress has only roughed in its program.

Anderson v. Butz, 428 F. Supp. 245, 251 (E.D.Cal. 1975) (quoting *Kelly v. U.S. Dep't. of the Interior*, 339 F. Supp. 1095, 1102 (E.D.Cal. 1972)).

[1] This Report does not address, and accordingly we express no opinion on, whether the NCUA Board possesses statutory authority to implement the OTR in the manner described in Section I.

I. HISTORY OF THE OTR

The NCUA, an independent federal agency established by the FCUA, charters FCUs and supervises both FISCUs and FCUs insured by the NCUSIF. The NCUA Board administers the NCUSIF, which was created in 1970 as a revolving fund in the United States Treasury to insure the accounts of FCUs and FISCUs.[2] The FCUA provides that the NCUA's expenses incurred in carrying out the examination and supervision of FCUs may be covered by operating fees assessed on FCUs.[3] The FCUA also provides that the NCUA Board may requisition funds from the NCUSIF to cover certain expenses.[4]

In 1972, the U.S. General Accounting Office[5] recommended that "insurance-related" and regulatory related costs be allocated between the NCUA and NCUSIF. The GAO observed that, during 1971 and 1972, the NCUA Board tried several different methods in attempts to develop an equitable method to allocate costs to the NCUSIF. The GAO, however, was unable to determine if the operating expenses presented on the NCUSIF's statement of income and expenses for that period were fairly stated because different methods were used and the GAO was unable to verify the basis used to make certain allocations.[6]

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[2] 12 U.S.C. § 1783.
[3] 12 U.S.C. § 1755.
[4] *See, e.g.*, 12 U.S.C. 1783(a). As noted in the Executive Summary, this Report does not address and accordingly we express no opinion on whether the NCUA Board possesses statutory authority to implement the OTR as described in this Section.
[5] Now known as the U.S. Government Accountability Office ("GAO").
[6] Comptroller General of the United States Report 74-0204, *Examination Of Financial Statements Of The National Credit Union Administration For The Periods Ended June 30, 1971 and 1972 Limited By Restriction On Access To Credit Union Examination Records*, pp. 14-15 (Sept. 1973).

In the following years until 1986, various cost allocation methodologies were implemented by the NCUA Board, including direct charges to the NCUSIF for insurance expenses (*e.g.*, cost of closing institutions and liquidation and merger costs), the cost of NCUSIF's full-time employees and the cost of the time NCUA's employees spent on NCUSIF examination and supervision activities.[7]

From 1986 through 1994, the NCUA's Office of Examination and Insurance conducted annual surveys of NCUA examiners to determine how much time examiners spent on insurance-related and non-insurance-related matters. The relative proportion of time spent by examiners on insurance–related matters was the principal factor that determined the OTR. During this ten year period, the survey results on the percent of "insurance-related" time spent by NCUA examiners varied between 50.1% and 60.4% of their total hours worked. Notwithstanding this range, the NCUA maintained the budgeted OTR at 50% of the NCUA's annual budget for the years 1986 through 1994.[8]

Based on a staff study conducted in 1994, the NCUA Board approved a 50% budgeted OTR for the three year period 1995-1997, and committed to re-evaluate the OTR in 1997. An in-depth study of examination time conducted in 1997 concluded that examiners spend approximately 50% of their time on insurance-related functions. As a result, in 1997, the NCUA Board approved a 50% budgeted OTR for the period 1998-2000.

[7] In October 1985, the NCUA Board determined to eliminate the direct NCUSIF employee expense from the calculation of the OTR.
[8] Starting in 1989, the NCUA tapped the NCUSIF for certain of its expenses by means other than through the OTR. These included expenses incurred in connection with operating the Asset Liquidation Management Center and costs associated with training state examiners. These additional expenditures were not included in the NCUA's calculation of the budgeted OTR. If these expenses, for example, had been added to the OTR in 1989 (approximately $2 million), the OTR for that year would have increased to 53.6%. The OTR rates presented below do not include recoveries of NCUA expenses by means other than the OTR and FCU Operating Fees.

In 2000, the scope and methodology of the examiner survey was revised to include principal examiners, regional staff and central office staff. These revisions resulted in a dramatic increase in the budgeted OTR from 50% to 66.7% of the NCUA's annual budget for 2001 and 62% of the NCUA's annual budget for 2002 and 2003. During this 2000-2003 time period, the NCUA's annual budget increased 8.2% (from $135.0 million to $146.1 million) and its actual expenses increased 5% (from $127.6 million to $134.1 million). Importantly, however, the NCUA's expenses paid from the NCUSIF through the OTR increased 30.4% (from $63.8 million to $83.2 million) as a result of the increase in the OTR. In contrast, during the 1995-2000 time period during which the budgeted OTR remained constant at 50%, the percentage increase in NCUA expenses covered by the NCUSIF through the OTR (44.3%) corresponded to the percentage increases in the NCUA's annual budget (45.6%) and actual expenses (44.5%) during this time period.

In November 2003, the NCUA Board again revised the methodology for calculating and assessing the OTR. Key components of this new OTR calculation methodology included the results of the annual Examination Time Survey performed by a randomly selected group of principal examiners, NCUA's resource workload budget, NCUA's financial budget, the distribution of insured assets between FCUs and FISCUs, and an estimate of the "insurance-related" work conducted by state regulators.

Using this methodology, the OTR gradually declined between 2004 and 2008 as follows:

BUDGETED OTR AS A PERCENT OF NCUA ANNUAL BUDGET

YEAR	OTR
2004	59.8%
2005	57.0%
2006	57.0%
2007	53.3%
2008	52.0%

Attributed in part to increased NCUSIF-related activities due to macroeconomic developments, the budgeted OTR increased modestly between 2009 and 2013 as follows:

BUDGETED OTR AS A PERCENT OF NCUA ANNUAL BUDGET

YEAR	OTR
2009	53.8%
2010	57.2%
2011	58.9%
2012	59.3%
2013	59.1%

For the 2014 OTR, the NCUA Board adopted new mapping of NCUA regulations based on the extent to which, in the NCUA Board's view, each statute and regulation administered by the NCUA is designed to protect the NCUSIF and is therefore "insurance-related." Previously, for purposes of the Examination Time Survey, examiner activities were classified into two categories – "insurance-related" (*i.e.*, related to NCUA Board's role as an insurer of federally insured credit unions) and "regulatory-related" (*i.e.*, related to NCUA's role as a regulator and charterer of credit unions). For the 2014 OTR, "insurance-related" was separated into two categories: (1) "Insurance Related Examination" and (2) "Insurance Regulatory Related Examination." The former "regulatory-related" category was re-defined as the third category, "Consumer Regulatory Related Examination." Of the 252 rules and regulations identified by the NCUA as examination related, approximately 161 (64%) are categorized as "Insurance Regulatory Related Examination" and presumably included in the OTR. Approximately 91 or (36%) are categorized as "Consumer Regulatory Related Examination" and presumably excluded from the OTR. Based on this new mapping, the NCUA Board now appears to consider virtually all activities related to safety and soundness regulations to be "insurance-related" and therefore included in the determination of the OTR. The only regulatory activities that appear not to be included in the OTR are generally those that relate to consumer regulations.[9] Based on this new mapping, NCUA "insurance-related" examiner time increased from 67% for purposes of determining the 2013 OTR to 88% for the calculation of the 2014 OTR, with a resulting increase in the budgeted OTR from 59.1% in 2013 to 69.2% of NCUA budgeted total expenses in 2014,[10] a 17.1% year-over-year increase in the budgeted OTR.

As a consequence of this increase in the 2014 budgeted OTR, the budgeted contribution of FISCUs through the 2014 OTR to the NCUA 2014 Operating Budget increased to $85.6 million, which represents an $18.6 million (27.8%) increase over their 2013 contribution of $67.0 million.[11] The budgeted contribution of FCUs through the 2014 OTR to the NCUA 2014 Operating Budget increased to $100.1 million compared to their 2013 contribution of $79.0 million, which represents a $21.1 million increase (26.7%), which at first

[9] These statutes and regulations include: Equal Credit Opportunity Act (Regulation B); Bank Secrecy Act; Home Mortgage Disclosure Act (Regulation C); Expedited Funds Availability Act (Regulation CC); Children's Online Privacy Protection Act; Reserve Requirements (Regulation D); Electronic Fund Transfer Act (Regulation E); Fair and Accurate Credit Transactions Act; Fair Credit Reporting Act (Part 717); Fair Debt Collection Practices Act; Flood Disaster Protection Act; Fair Housing Act; Gramm-Leach-Bliley Act; Home Ownership and Equity Protection Act; Home Owner's Protection Act; Regulation M (Consumer Leasing); Office of Foreign Assets Control requirements; Privacy of Consumer Financial Information; Right to Financial Privacy Act; Service Members Civil Relief Act; Real Estate Settlement Procedures Act (Regulation X); Truth in Lending Act (Regulation Z); and Credit Practices (Part 706); and Truth in Savings Act (Part 707).

[10] This Report uses budgeted percentages and budgeted amounts for 2014 because the NCUA has not as of the date of this Report issued operating and financial results for 2014.

[11] The NCUA total budget for 2014 was $ 268.3 million, which represented a $26.5 million (11%), increase over its 2013 actual expenses of $241.8 million.

glance appears comparable to the percentage increase experienced by FISCUs. However, the increase of the OTR had a major impact on reducing FCU Operating Fees, which represent actual out-of-pocket expenditures for FCUs. By increasing the OTR, the NCUA Board was able to shift a substantial portion of NCUA expenses to the NCUSIF, thereby enabling it to reduce FCU Operating Fees for 2014. As a result, FCU Operating Fees in 2014 were budgeted to be $82.6 million, versus $93.1 million in 2013, a decrease of $10.5 million, or an 11.3% reduction compared to 2013, despite a $26.5 million (11%) increase in the NCUA Operating Budget for 2014.

The 2015 budgeted OTR not only continued this trend but, as applied, resulted in an even larger reduction in FCU Operating Fees than in 2014. Continuing to utilize this same mapping, NCUA "insurance-related" examiner time for purposes of determining the 2015 budgeted OTR was reported as 87.8%. The budgeted OTR for 2015 increased to 71.8% of NCUA budgeted total expenses. This represents a 21.5% increase in the 2015 budgeted OTR from 2013.

The budgeted contribution of FISCUs through the 2015 OTR to the NCUA 2015 Operating Budget increased to $93.9 million, which represents a $26.9 million (40.1%) increase over their 2013 contribution of $67.0 million.[12] The budgeted contribution of FCUs through the 2015 OTR to the NCUA 2015 budget increased to $106.8 million compared to their 2013 contribution of $79.0 million, which represents a $27.8 million (35.1%) increase.

As in 2014, the increase in the budgeted OTR will have a significant impact in reducing FCU Operating Fees in 2015. FCU Operating Fees in 2015 were budgeted to be $78.8

[12] The NCUA total budget for 2015 was $279.5 million, which represented a $37.7 million (15.5%) increase over its 2013 actual expenses of $241.8 million.

million, a $3.8 million (4.8%) decrease from budgeted FCU Operating Fees for 2014. More telling is the comparison of FCU Operating Fees between 2013, the last year before the new mapping of NCUA regulations discussed above, and 2015. FCU Operating Fees in 2015 were budgeted to be $78.8 million, versus $93.1 million in 2013, a decrease of $14.3 million, or an 18.1% reduction compared to 2013, despite a $37.7 million (15.6%) increase in the NCUA expenses from 2013 to those expected in 2015.

The increase in the 2014 budgeted OTR and 2015 budgeted OTR resulting in large part from this new mapping of NCUA regulations discussed above, as compared to the budgeted OTR for 2013, the last year before this new mapping, is as follows:

BUDGETED OTR AS A PERCENT OF NCUA ANNUAL BUDGET

YEAR	OTR
2013	59.1%
2014	69.2%
2015	71.8%

As a result of the NCUA Board's increases in the OTR discussed in this Section, FCUs have enjoyed a significant reduction in the FCU Operating Fees they otherwise would have been required to pay directly to the NCUA.

The following chart summarizes the impact of the OTR on the amount of NCUA total expenses incurred by FISCUs and FCUs for the period 2009-2015.

IMPACT OF NCUA OTR

($ in millions)

Year	NCUA Expenses[13]	NCUA Expenses Allocated to NCUSIF[14]	Budgeted OTR[15]	Actual OTR[16]	FISCUs share of NCUA Expenses Allocated to NCUSIF[17]	FCUs share of NCUA Expenses Allocated to NCUSIF[18]	FCU Operating Fees[19]
2009	$167.7	$ 90.2	53.8%	53.8%	$40.9	$49.3	$81.7
2010	$200.9	$113.6	57.2%	56.5%	$51.6	$62.0	$86.8
2011	$216.1	$130.0	58.9%	60.2%	$59.3	$70.7	$86.2
2012	$228.0	$137.5	59.3%	60.3%	$52.7	$74.8	$88.8
2013	$241.8	$146.0	59.1%	60.4%	$67.0	$79.0	$93.1
2014[20]	$268.3	$185.7	69.2%	--	$85.6	$100.1	$82.6
2015[21]	$279.5	$200.7	71.8%	--	$93.9	$106.8	$78.8

[13] Source: NCUA Annual Report, except for 2014 and 2015.
[14] The allocation to NCUSIF is 100% of the expenses of the Office of National Examinations and Supervision (Office of Corporate Credit Unions) to the extent that they exceed the actual operating fees paid by federal corporate credit unions (for the years where applicable), plus the OTR applied to all other expenses. Source: NCUA Annual Report, except for 2014 and 2015.
[15] As approved by NCUA Board for the calendar year.
[16] The Actual OTR is calculated by dividing the NCUA Expenses Allocated to NCUSIF column by the NCUA Expenses column. The Actual OTR can differ from the Budgeted OTR column because the actual NCUA Expenses and actual NCUA Expenses Allocated to NCUSIF for a given year may differ from the budgeted NCUA Expenses and budgeted NCUA Expenses Allocated to NCUSIF for that year. In addition, any recovery of NCUA expenses from the NCUSIF other than through the OTR are included in the Actual OTR calculation.
[17] Based on FISCUs share of total NCUSIF insured shares, as reported by NCUA Board for the calendar year.
[18] Based on FCUs share of total NCUSIF insured shares, as reported by NCUA Board for the calendar year.
[19] Source: NCUA Annual Report, except for 2014 and 2015.
[20] Source: NCUA Board estimates for 2014 as reported in Board Action Memorandum, dated November 20, 2013, from Office of Examination and Insurance to NCUA Board, Re: Overhead Transfer Rate 2014.
[21] Source: NCUA Board estimates for 2015 as reported in Board Action Memorandum, dated November 20, 2014, from Office of Examination and Insurance to NCUA Board, Re: Overhead Transfer Rate 2015.

II. ANALYSIS OF THE ADMINISTRATIVE PROCEDURE USED BY THE NCUA TO IMPLEMENT THE OTR

A. *NCUA BOARD'S IMPLEMENTATION PROCEDURE*

The NCUA Board in the past has held annual public briefings and forums on its Operating Budget, of which the OTR is a significant component. The last public briefing and forum was held by the NCUA Board in 2008. The NCUA Board has also received comment on the OTR outside of these public briefings and forums.[22] However, the NCUA Board has never formally requested comment by publishing in the *Federal Register* a proposed OTR, a proposed methodology for calculating the OTR or proposed changes to its methodology for calculating the OTR.

The NCUA Board also in our view has never provided a reasoned, comprehensive explanation of its OTR methodology, including how the activities it defines for this purpose as "insurance-related" are actually related to insurance, and why it has changed its position over time as to what constitutes "insurance-related activities." Since at least 2008, the NCUA Board has released an annual Board Action Memorandum prepared by the Office of Examination and Insurance which prescribes the Office of Examination and Insurance's recommendation for the OTR for the following year. This 2-3 page memorandum (with an attachment that contains only tables without textual explanation) provides only a summary description of the methodology used to calculate the OTR, including during years in which that methodology changed. For example, in its November 20, 2013 memorandum recommending the OTR for 2014, which as discussed in Section I increased materially based on a revised OTR methodology, the Office of

[22] As indicated below, the NCUA staff has stated that one of the reasons for its consideration of the OTR for 2012 was in part in response to industry comment, but did not mention that it considered the need for formal APA-compliant notice and comment.

Examination and Insurance provided only the following two paragraph explanation of the change to the OTR methodology:

> In 2012, the Office of Examination and Insurance (E&I) clarified the application of the insurance-related and non-insurance related definitions in the ETS [Examiner Time Survey] in response to industry and examiner comments. This clarification involved how examiners record on the ETS time they spend examining for compliance with various regulations. Specifically, the NCUA rules and regulations were individually mapped to the proper ETS category based on the extent to which a regulation was designed to protect the NCUSIF (a new sub-category of insurance related labeled "insurance-regulatory") or to govern commerce and/or provide consumer protection (labeled "non-insurance or consumer regulatory").
>
> This breakdown and mapping of regulations is consistent with the existing overall definitions of insurance-related and non-insurance related. The primary definitions have not changed; the regulations have merely been explicitly mapped based on the overarching definitions. While examiners continue to use their judgment as to what exam procedures to perform during an examination or supervision contact based on the risks and product-service mix of credit union, this clarification creates more consistency as to where examiners record the time on the ETS.[23]

Notwithstanding this statement of the Office of Examination and Insurance that this mapping "is consistent with" the previously utilized definitions of insurance-related and non-insurance related, it appears that certain NCUA regulatory activity that was previously considered "regulatory-related" and therefore not included in the OTR was recast as a result of this mapping as "Insurance Regulatory Related Examination" for purposes of, and included in, the 2014 OTR. Although the Office of Examination and Insurance then references a 2013 PricewaterhouseCoopers review of the mapping of NCUA regulations to the categories on the ETS (discussed further below) which was attached to its memorandum, nowhere in that

[23] Office of Examination and Insurance Memorandum to NCUA Board, Overhead Transfer Rate 2014, p. 2 (November 20, 2013), available at http://www.ncua.gov/about/Documents/Agenda%20Items/AG20131121Item5a.pdf.

memorandum or in the attached PricewaterhouseCoopers review is an explanation provided as to why each particular regulation is considered "insurance-regulatory" or "non-insurance or consumer regulatory" for purposes of the OTR calculation.

The adjustment made by the NCUA Board to the OTR for the value to the NCUSIF of the insurance-related supervision provided by the state supervisory authorities and relied upon by the NCUA in managing the NCUSIF provides another example of the NCUA Board's failure to provide a reasoned, comprehensive explanation of its OTR methodology. For the 2015 OTR, this adjustment, referred to by the NCUA Board as the "Imputed SSA Value," was $41.56 million, approximately 14.9% of the 2015 NCUA budgeted expenses. Although the annual Board Action Memorandum prepared by the Office of Examination and Insurance includes a 4-step worksheet for the Imputed SSA Value calculation, no textual explanation is provided describing the methodology used for the Imputed SSA Value calculation nor are the sources for certain of the calculation inputs explained. Notwithstanding the significance of this Imputed SSA Value to the OTR calculation, the NCUA Board has never explained why it has determined to make this adjustment rather than, for example, pay the state supervisory authorities directly from the NCUSIF or use alternative methodologies to make this adjustment.[24]

In addition, we are not aware of any independent third party determination that the NCUA Board's OTR methodology complies with the FCUA or other applicable law. In a report

[24] The NCUA Board has not explained, for purposes of the SSA Imputed Value: (i) why it uses the examination and supervision hours spent for FCUs by asset size and CAMEL rating and the NCUA Examination Time Survey, rather than the state supervisors' actual FISCUs "insurance-related" examination and supervision hours; (ii) why it assumes a 50-50 allocation for the insurance-related work in current FISCUs joint examinations; (iii) why it uses the larger, rather than the smaller or an average of, the exam hour calculations (current budgeted state exam insurance hours and projected FISCUs exam insurance hours based on the Examination Time Survey); (iv) the basis for the adjustment increase for Budgeted Supervision Hours; and (v) the NCUA staffing models and productivity levels used to translate additional workload hours to staff positions and the imputed cost of these positions.

issued January 20, 2011, PricewaterhouseCoopers evaluated the reasonableness and soundness of the methodology adopted by the NCUA Board in the calculation and administration of the OTR. But PricewaterhouseCoopers indicates in this report that it "does not express an opinion related to any issues that may be perceived with regards to NCUA's dual role as regulator and insurer, oversight or lack thereof of NCUA's budget or an interpretation of Congressional intent behind Title II of the Federal Credit Union Act of 1970 which established NCUSIF."[25] As discussed above, PricewaterhouseCoopers in 2013 analyzed the NCUA Board's proposed mapping of its rules and regulations resulting in the 2014 OTR. However, PricewaterhouseCoopers states in that report that its review "does not constitute an audit or evaluation of the administration and execution of the [Examination Time Survey], the overhead transfer rate (OTR) methodology or resulting OTR calculation."[26]

B. *THE ADMINISTRATIVE PROCEDURE ACT*

Under the APA, an agency such as the NCUA must follow APA-specified notice and comment requirements for its "rule making." "Rule making" is defined in the APA as an agency process for formulating, amending, or repealing a "rule."[27] "Rule," in turn, is defined as:

> [T]he whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services or allowances therefor or of

[25] Overhead Transfer Rate Review For National Credit Union Administration, PricewaterhouseCoopers, p. 3 (January 20, 2011).
[26] National Credit Union Administration Analysis of Examination Time Survey (ETS) Modifications, PricewaterhouseCoopers, page 1 (October 2, 2013), available at http://www.ncua.gov/about/Documents/Agenda%20Items/AG20131121Item5b.pdf.
[27] 5 U.S.C. § 551(5).

valuations, costs, or accounting, or practices bearing on any of the foregoing.[28]

When an agency is engaged in APA "rule making," the agency must: (1) publish a general notice of proposed rule making in the *Federal Register* that includes "the terms or substance of the proposed rule or a description of the subjects and issues involved;" (2) give "interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments;" and (3) "[a]fter consideration of the relevant matter presented . . . incorporate in the rules adopted a concise general statement of their basis and purpose."[29]

Courts are charged with ensuring that agencies comply with the procedural requirements of the APA. *Chrysler Corp. v. Brown*, 441 U.S. 281, 313 (1979).

The OTR, and the methodology used by the NCUA Board to calculate the OTR, is an NCUA Board statement of general applicability and future effect designed to implement and interpret the FCUA provisions addressing the OTR, as expressly contemplated by the APA definition of "rule." Also, because the OTR affects the NCUSIF coverage ratio as well as FCU Operating Fees, it is an "approval or prescription for the future of rates, financial structure, facilities, appliances, services or allowances, costs and/or accounting or practices bearing on any of the foregoing," as expressly contemplated by the APA's definition of "rule."

The OTR apportions to FISCUs through the NCUSIF assessment a significant percentage of NCUA total costs (33.6% or $93.9 million of NCUA budgeted costs for 2015). In addition, although FCUs also pay a significant percentage of NCUA costs through the OTR (38.2% or $106.8 million of NCUA budgeted costs for 2015), increases in the OTR have the

[28] 5 U.S.C. § 551(4).
[29] 5 U.S.C. §§ 553 (b), (c).

effect of substantially reducing FCU Operating Fees because of the shift of NCUA expenses from FCUs to the NCUSIF, which is funded by all federally insured credit unions. For example, FCU Operating Fees budgeted for 2015 dropped $14.3 million (18.1%) as compared to the 2013 FCU Operating Fees, notwithstanding a $37.7 million (15.6%) increase in the NCUA Operating Budget from 2013 to 2015. This was due to the increase in the budgeted OTR from 59.1% in 2013 to 71.8% in 2015, which resulted in large part from the change in the OTR calculation methodology for the 2014 and 2015 budgeted OTR discussed in Section I.

As a result, the competitive position of FISCUs relative to FCUs was adversely impacted by the change in OTR methodology for the 2014 and 2015 budgeted OTR and the resultant increase in the budgeted OTR for 2014 and 2015 relative to 2013. That is, during this two year time period, FISCUs have borne an increasing percentage of NCUA expenses, whereas FCUs enjoyed a substantial reduction of $10.5 million (11.3%) in their out-of-pocket FCU Operating Fees between 2013 and 2014 and an additional budgeted reduction of $3.8 million (4.8%) between 2014 and 2015, for a total budgeted reduction between 2013 and 2015 of $14.3 million (18.1%) from 2013 to 2015. Further, an increase in the OTR combined with the same or increased NCUA expenses decreases the likelihood and amount of any *pro rata* distribution to federally insured credit unions provided for in 12 U.S.C. § 1782(c)(3). Accordingly, barring the applicability of one of the APA exceptions discussed later in this Section, based upon the effect on FISCUs and FCUs, we believe the NCUA Board calculation of the OTR is a "rule" subject to APA notice and comment requirements.

Indeed, given its impact on federally insured credit unions generally and the adverse effect on the competitive position of FISCUs relative to FCUs, we believe the NCUA Board's adoption of the OTR should be deemed a major rule for purposes of the APA.[30] In addition to the APA requirements discussed above, major rules should contain: (i) a statement of purpose providing the underlying reason for the rule; (ii) monetized or quantified costs and benefits or a qualitative discussion of them; and (iii) a discussion of the alternatives.[31]

The APA contains certain exceptions to its notice and comment requirements.[32] As a general matter, "[t]he legislative history of the [APA] demonstrates that Congress intended the exceptions in § 553(b)(B) to be narrow ones." *Nat'l Nutritional Foods Ass'n v. Kennedy*, 572 F.2d 377, 384 (2d Cir. 1978). "Congress expected, and the courts have held, that the various exceptions to the notice-and-comment provisions of section 553 will be narrowly construed and only reluctantly countenanced." *N.J. Dep't of Envtl. Prot. v. EPA*, 626 F.2d 1038, 1045 (D.C. Cir. 1980).

The first exception from the APA notice and comment requirements is for "rules of agency organization, procedure or practice."[33] The general approach that courts have followed in determining the applicability of this exception is whether the rule in question has a substantive impact of broad applicability. In *Minard Run Oil Company v. United States*, 670 F.3d 236 (3d Cir. 2011), the Third Circuit Court of Appeals rejected the government's contention that the Forest Service's new requirement that companies proposing to drill on federal land complete a forest-wide environmental impact statement was a rule of agency organization, procedure or

[30] Major rules are defined by the Congressional Review Act as rules that will likely result in: (i) an annual effect on the economy of $100 million or more; (ii) major increases in cost or prices for consumers, individual industries, federal, state or local government agencies, or geographic regions, or (iii) significant adverse effects on competition, employment, investment, productivity, or innovation, or on the ability of U.S.-based enterprises to compete with foreign-based enterprises in domestic and export markets. 5 U.S.C. § 804(2). The Office of Management and Budget's Office of Information and Regulatory Affairs is responsible for making major rule designations for independent regulatory ageneies such as the NCUA. 5 U.S.C. § 804(2).
[31] *See*, United States General Accounting Office Report 14-714, *Federal Rulemaking* (Sept. 2014).
[32] 5 U.S.C. § 553(b).
[33] 5 U.S.C. § 553(b)(3)(A).

practice because the purpose and effect of this rule was to prevent new drilling by mineral rights owners during the course of the multi-year environmental impact statement. Additionally, the court also considered whether the rule in question would "have a substantial adverse impact on the challenging party." The court, citing *SBC, Inc. v. FCC*, 414 F.3d 486, 497-98 (3d Cir. 2005), explained that "rules of agency organization, procedure or practice" do not themselves shift the rights or interests of the parties, although they may change the way in which parties present themselves to the agency. The court concluded that, in contrast, rules that work substantive changes in prior regulations, or create new law, rights, or duties, are subject to the notice and comment requirements of the APA.

Similarly, in *Anderson*, the U.S. District Court for the Eastern District of California rejected the government's argument that an instruction of the Secretary of Agriculture that the calculation of household income for food stamp users was to include the amount of government rent subsidies paid directly to a low income housing tenant's landlord was not subject to APA notice and comment because it was a rule of agency organization, practice or procedure. The court explained that "a significant difference exists between interpretive rules and general statements of policy which affect only the internal operations or actions of an agency and those rules which affect the substantive rights of others outside of the agency. Requiring publication of notice of proposed rule making with invitation to comment makes little sense if only internal operations or management of the agency are involved since agency actions on these matters would have no direct effect upon the substantive rights of persons outside the agency." The court concluded that APA notice and comment was required for this rule change because substantive rights of persons outside the agency who are receiving rent subsidies are directly affected by the instruction because it raises the cost of their allocated food stamps. The

Secretary's instruction, according to the court, was therefore not a mere matter of agency management. The court cited several cases that have held that agency rulemaking is subject to APA notice and comment if it substantially affects the rights of persons subject to agency regulations, including *Pickus v. U.S. Board of Parole*, 507 F.2d 1107 (D.C. Cir. 1972); *Lewis-Mota v. Secretary of Labor*, 469 F.2d 478 (2d Cir. 1972); *Texaco, Inc. v. Federal Power Commission*, 412 F.2d 740 (3d Cir. 1969). The court explained why it is "important and proper that before an agency undertakes to promulgate rules affecting substantive rights of others outside the agency, there should be an opportunity afforded for an exchange between those whose rights are affected and the government." Quoting *Kelly*, the court stated:

> Voiding the present regulations on what at first blush appears to be a technicality is not as pointless as it may seem. We believe that the 30-day notice rule serves an important interest, the right of the people to present their views to government agencies which increasingly permeate their lives. The interchange of ideas between the government and its citizenry provides a broader base for intelligent decision-making and promotes greater responsiveness to the needs of the people, especially in cases such as this where Congress has only roughed in its program.

Anderson, 428 F. Supp. at 251 (quoting *Kelly*, 399 F.Supp. at 1102).

Given the widespread effect of the OTR on federally insured credit unions generally and FISCUs particularly, we do not believe that the NCUA could justify its failure to follow APA notice and comment procedures on the grounds that the OTR comes within the APA exception for a rule of "agency organization, procedure or practice" under 5 U.S.C. § 553(b)(3)(A).

The APA also provides that publication of notice and opportunity for comment are not required for "interpretative rules" or "general statements of policy."[34] As the courts often have analyzed these two exceptions in the same manner and sometimes use these exceptions interchangeably, we consider them together. The courts generally draw a distinction between "interpretive rules" or "general statements of policy" on the one hand for which no notice or comments is required under the APA, and "substantive rules" or "legislative rules" on the other hand for which APA notice and comment is required.

Substantive rules affect individual rights and are binding on the courts, whereas interpretive rules leave the agency free to exercise discretion. *Williams v. Van Buren*, 117 F. App'x 985, 986 (5th Cir. 2004) (*per curiam*). The critical feature of interpretive rules is that they are issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers; interpretive rules do not have the force and effect of law and are not accorded that weight in the adjudicatory process. *Perez v. Mortgage Bankers Ass'n,* 135 S. Ct. 1199 (2015). An example of an interpretive rule would be where the agency intends merely to publish a policy guideline that is subject to attack when it is finally applied in future cases. *Pac. Gas & Elec. Co. v. FPC*, 506 F.2d 33, 39 (D.C. Cir. 1974); *see also, Doe v. Hampton*, 566 F.2d 265, 280-81 (D.C. Cir. 1977).

The D.C. Circuit Court of Appeals has described the distinction between legislative rules, interpretive rules and policy statements as follows:

> An agency action that purports to impose legally binding obligations or prohibitions on regulated parties -- and that would be the basis for an enforcement action for violations of those obligations or requirements -- is a legislative rule...(As to interpretive rules, an agency action that merely

[34] 5 U.S.C. § 553(b)(3)(A).

> interprets a prior statute or regulation, and does not itself purport to impose new obligations or prohibitions or requirements on regulated parties, is an interpretive rule.) An agency action that merely explains how the agency will enforce a statute or regulation—in other words, how it will exercise its broad enforcement discretion or permitting discretion under some extant statute or rule -- is a general statement of policy.

Nat'l Mining Ass'n v. EPA, 758 F.3d. 243, 251-52 (D.C. Cir. 2014).

In distinguishing between legislative rules and general statements of policy, the D.C. Circuit has long been guided by two important factors: "the actual legal effect (or lack thereof) of the agency action in question on regulated entities," and the "agency's characterization" of the agency action. *Nat'l Mining Ass'n*, 758 F.3d at 252. The first factor "focuses on the effects of the agency action" asking whether the agency has "(1) impose[d] any rights and obligations, or (2) genuinely [left] the agency and its decisionmakers free to exercise discretion." *Wilderness Soc'y v. Norton*, 434 F.3d 584, 595 (D.C. Cir. 2006) (quoting *CropLife Am. v. EPA*, 329 F.3d 876, 883 (D.C. Cir. 2003)). The second factor looks to the agency's expressed intentions: "(1) the [a]gency's own characterization of the action; (2) whether the action was published in the *Federal Register* or Code of Federal Regulations; and (3) whether the action has binding effects on private parties or the agency." *Wilderness Soc'y*, 434 F.3d at 595 (quoting *Molycorp v. EPA*, 197 F.3d 543, 545 (D.C. Cir. 1999)).

To determine whether a rule is a substantive or legislative rule rather than an interpretive rule, the D.C. Circuit applies a four-factor test that considers: (1) whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties; (2) whether the agency has published the rule in the Code of Federal Regulations; (3) whether the agency has explicitly invoked its general legislative authority, and (4) whether the rule effectively amends a prior legislative rule. Generally, if any one of these prongs is satisfied, the rule is legislative rather than interpretive. *Am. Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1112 (D.C. Cir. 1993).

Credit Union Nat'l Ass'n v. Nat'l Credit Union Admin., 573 F. Supp. 586 (D.D.C. 1983) is particularly instructive as to whether a court would view the OTR as an "interpretive rule" or "general statement of policy" exempt from APA notice and comment requirements. This case involved the NCUA Board's adoption of new payout priorities for involuntary liquidating FCUs under Subchapter II of the FCUA without APA notice or comment. NASCUS and the Credit Union National Association ("CUNA") challenged on the basis that the NCUA Board's adoption of new payout priorities constituted a rule which required the NCUA Board to comply with APA notice and comment requirements. The U.S. District Court for the District of Columbia determined the new payout priorities were substantive or legislative rules, rather than interpretative rules as contended by the NCUA Board, and therefore subject to APA notice and comment requirements. The court explained that the proper analysis for this purpose was articulated in *Wine Co. v. Snyder*, 194 F.2d 329, 331 (D.C. Cir. 1952):

> In applying the Gibson Wine test, however, "there is no 'reason to doubt the continuing vitality of the substantial impact test as . . . one of several criteria for evaluating claims of exemption from [the APA].' " *Cabais*, 690 F.2d at 237, quoting *Batterton*, 648 F.2d at 709 n.83.
>
> Under this analysis, it is inescapable that [the NCUA Board's rule in question] is a legislative rather than an interpretive rule, despite NCUA's own characterization. Such agency labels, although "entitled to a significant degree of credence," *Cabais*, 690 F.2d at 238 n.7; *British Caledonian*, 584 F.2d at 992, are not dispositive. Here, the [NCUA] Board clearly issued [the NCUA Board's rule in question] to implement its mandate to make payments as liquidating agent for closed federal credit unions pursuant to 12 U.S.C. § 1787(a)(2). The agency's "intent" -- a factor the Court must take into account -- is revealed by the rule's effect and not only by its characterization. *Chamber of Commerce of the United States v. OSHA*, 204 U.S. App. D.C. 192, 636 F.2d 464, 468 (D.C. Cir. 1980), quoting *Columbia Broadcasting System, Inc. v. United States*, 316 U.S. 407, 416, 86 L. Ed. 1563, 62 S. Ct.

> 1194 (1942). The Board stated that its intent was "to make . . . a change to the payout priority," in accordance with the GAO's recommendation. Although the statute itself is silent on the matter of payout priorities, the Board relied on its own authority to 'establish[]' priorities. Such legislative action by an agency cannot be disguised by the simple semantic maneuver of claiming it 'explains' or 'clarifies 12 U.S.C. §§ 1787(a)(2) and 1787(d). *See e.g.*, *Chamber of Commerce*, 204 U.S. App. D.C. 192, 636 F.2d 464; *American Bus Association v. United States*, 201 U.S. App. D.C. 66, 627 F.2d 525 (D.C. Cir. 1980). Defendant implicitly recognizes the true character of [the NCUA Board's rule in question] by describing the rule as giving 'operational meaning' to the statute. (Defendant's memorandum in support of its motion at p. 15.) The Board's decision to apply the new priority scheme prospectively only is a further indication that its effect is to create new law and not merely to interpret existing law.
>
> Because [the NCUA Board's rule in question] is not an 'interpretive rule,' it must be vacated for failure to comply with the APA's notice and comment requirements.

Credit Union Nat'l Ass'n, 573 F. Supp. at 591.

As with the NCUA Board's payout priorities for involuntary liquidating FCUs at issue in *Credit Union Nat'l Ass'n*, we believe that the NCUA Board's OTR similarly should be found to be a substantive rule subject to APA notice and comment. As with the NCUA Board's payout priorities for involuntary liquidating FCUs, the OTR creates new law by implementing the provisions of the FCUA addressing the OTR with substantial effect without further NCUA action on federally insured credit unions in general and FISCUs in particular. Applying the test developed by the D.C. Circuit confirms that the OTR is a substantive or legislative rule subject to the notice and comment requirements of the APA. In the absence of the OTR, there would not be an adequate legislative basis for the NCUA to shift its expenses to federally insured credit unions by requisitioning funds from the NCUSIF to cover expenses, nor has the NCUA published the OTR in the *Federal Register* or in the Code of Federal Regulations. Moreover, the NCUA has stated that it is relying on its authority under the FCU Act to establish the OTR.

Finally, by continuing to alter the methodology for computing the OTR, the NCUA has effectively amended its prior OTR rules.

The final exception to the APA notice and comment requirements is the so-called "good cause" exception. The APA provides that notice and comment requirements do not apply "when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[35]

There is currently a conflict among the Circuits regarding the appropriate standard of review for an agency's assertion of good cause under 5 U.S.C. § 553(b)(3)(B). The Eighth Circuit defers to the agency's determination and reviews only whether the agency's determination of good cause complies with Congressional intent. *United States v. Gavrilovic*, 551 F.2d 1099 (8th Cir. 1977). This deferential standard appears similar to the approach taken by the Fifth and Eleventh Circuits, which each use an arbitrary and capricious standard. *United States v. Johnson*, 632 F.3d 912, 928 (5th Cir. 2011); *United States v. Dean*, 604 F.3d 1275, 1278 (11th Cir. 2010). The Fourth and Sixth Circuits; however, apply *de novo* review, which generally affords less deference to the determination of the agency in question. *United States v. Gould*, 568 F.3d 459, 469-70 (4th Cir. 2009); *United States v. Cain*, 583 F.3d 408, 420-21 (6th Cir. 2009).

Several Circuits have considered the Attorney General's finding that good cause existed to waive notice and comment for its regulations implementing the Sex Offender and Registration Notification Act. The Attorney General offered two rationales for waiving these

[35] 5 U.S.C. § 553(b)(3)(B).

requirements: (1) the need to eliminate "any possible uncertainty" about the applicability of the Act; and (2) concern that delay would endanger the public through the commission of additional sexual assaults and child sexual abuse or exploitation offenses by sex offenders that could have been prevented had the local authorities and communities been aware of the presence of the sexual predators, in addition to greater difficulty in apprehending perpetrators who have not been registered and tracked as provided in the Act.[36] Two Circuits, the Fourth and Eleventh, found good cause to exist to bypass notice and comment. *Gould*, 568 F.3d at 469-70 (interim rule necessary to provide "legal certainty about [the Act's] 'retroactive' application"); *Dean*, 604 F.3d at 1281 (public safety exception to notice and comment applied not only to true "emergency situations" but also to situations "where delay results in serious harm."). However, the Third, Fifth, Sixth, Eight and Ninth Circuits found that the Attorney General's stated reasons for finding good cause to bypass notice and comment were insufficient. *United States v. Reynolds*, 710 F.3d 498, 509 (3rd Cir. 2013); *Johnson*, 632 F.3d at 928; *Cain*, 583 F.3d at 421-24; *United States v. Brewer*, 2014 U.S. App. LEXIS 17454 (8th Cir. 2014); *United States v. Valverde*, 628 F.3d 1159, 1168 (9th Cir. 2010). For example, the Eighth Circuit determined that some uncertainty follows the enactment of any law that provides an agency with administrative responsibility, so that rationale if accepted by the court would justify an exception to notice and comment in all cases. The Eighth Circuit also found that the Attorney General's public safety rationale is nothing more than a rewording of the statutory purpose Congress provided in the text of the Act and delay in implementing a statute always will cause additional danger from the same harm the statute seeks to avoid. The Eighth Circuit then observed, although the risk of future harm may under some circumstances justify a finding of good cause, that risk must be more substantial than a mere possibility. Accordingly, the Eight Circuit determined that, even under an arbitrary and

[36] 72 *Fed. Reg.* 8894, 8896-97 (February 28, 2007).

capricious standard of review, there was an insufficient showing of good cause for bypassing the APA's requirement of notice and comment. *Brewer*, 2014 U.S. App. LEXIS at *5.

Based on the above judicial articulations of the good cause exception, the NCUA Board should not be able to rely upon this exception to justify its failure to provide for APA notice and comment for the OTR, regardless of the standard of review applied to the NCUA Board's assertion of good cause. If protection from sexual assaults and child sexual abuse or exploitation by sex offenders does not justify the good cause exception from APA notice and comment, it seems unlikely that any uncertainty or delay in applying the OTR would justify such an exception.

C. *PROCEDURES OF OTHER FEDERAL BANKING AGENCIES*

The procedures other federal banking agencies utilize to establish their fees and charges also is instructive of the APA procedural requirements for the OTR. The OCC establishes assessments and other fees for its examination and supervision of national banks and federal savings banks. The OCC follows an APA notice and comment process both for the methodology it uses for determining these assessments and fees, as well as for its actual assessments and fees.[37] The FDIC is less analogous to the NCUA than the OCC because the FDIC (unlike the NCUA and OCC) recovers all of its costs from insurance assessments, except for liquidation costs recovered from the estate of failed FDIC-insured banks. However, the FDIC utilizes an APA notice and comment process for its assessment methodology.[38] The

[37] *See*, 12 C.F.R. pt. 8, proposed for public comment at 76 *Fed. Reg.* 30557 (May 26, 2011); and 2014 OCC fees proposed for public comment at 79 *Fed. Reg.* 23297 (April 28, 2014).
[38] *See*, 12 C.F.R. pt. 327, proposed for public comment at 75 *Fed. Reg.* 66262 (October 27, 2010) (Notice of Proposed Rulemaking on Assessment Dividends, Assessment Rates and Designated Reserve Ratio). *See also*, Notices of Proposed Rulemaking on the Assessment System Applicable to Large Depository Institutions; 73 *Fed. Reg.* 15459 (March 24, 2008); 71 *Fed. Reg.* 28808 (May 18, 2006).

Federal Reserve Board, like the NCUA, has concurrent regulatory and other responsibilities and, for purposes of calculating Reserve Bank fees for priced services, allocates expenses between priced services and these other responsibilities. While the Federal Reserve Board does not solicit public comment on the fees for Federal Reserve Bank priced services, it does provide APA-compliant notice and comment on the methodology it uses to develop these fees.[39] In addition, as required under the Dodd-Frank Act, the Federal Reserve Board recently begun imposing assessments for bank holding companies and savings and loan holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated for Federal Reserve Board supervision by the Financial Stability Oversight Council equal to the total expenses the Federal Reserve Board estimates are necessary or appropriate to carry out its supervisory and regulatory responsibilities for these entities; and the Federal Reserve Board followed an APA-compliant notice and comment process for these new assessment fees.[40] The fact that these other federal banking agencies follow the APA notice and comment process for the methodology they employ in determining their assessments and fees and/or for the actual assessments and fees strongly supports the conclusion that the NCUA Board's adoption of the OTR constitutes a rule subject to the APA notice and comment requirements.

[39] *See e.g.*, 65 *Fed. Reg.* 82360 (December 28, 2000); 74 *Fed. Reg.* 15481 (April 6, 2009).

[40] 78 *Fed. Reg.* 23162 (April 18, 2013).

D. ***GAO REVIEW***

The GAO previously has recognized there are concerns with the procedures utilized by the NCUA Board to determine the OTR. After the NCUA Board abandoned its then long-standing policy of a 50% OTR and increased the budgeted OTR to 66.7% for 2001 and 62% for 2002 and 2003 as discussed in Section I, the GAO studied the methodology used by the NCUA Board for the 2001-2003 OTR. In explaining the importance of the OTR, the GAO stated that "[t]he sharp increase in the overhead transfer rate and its negative impact on NCUSIF's net income have raised questions about NCUA's process for determining the transfer rate."[41] The GAO noted in this study that the NCUA Board did not implement the GAO's recommendation in its 1991 report that the NCUA should establish separate supervision and insurance offices.[42] The GAO then concluded that "[a]s currently determined by the NCUA, the overhead transfer rate may not have accurately reflected the actual time spent by NCUA staff on insurance-related activities."[43] Following this 2003 GAO report, the NCUA Board revised its OTR methodology, which resulted in lower OTRs than during the 2001-2003 time period, until the NCUA Board again revised its methodology for the 2014 and 2015 OTR.

[41] United States General Accounting Office Report 04-91, *Credit Unions Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, p. 59 (Oct. 2003).
[42] *Id.*, at p. 61. *See also*, United States General Accounting Office Report 91-85, *Credit Union Reforms for Ensuring Future Soundness*, pp. 11-12, 186-192, 197 (July 1991).
[43] *Id.*, at pp. 81-82.

III. CONCLUSION

For the reasons discussed above, we believe that the NCUA Board's adoption of the OTR would be deemed to constitute a "rule" subject to APA notice and comment requirements. Because the NCUA Board has never followed this APA notice and comment process for the OTR, we believe the process utilized by the NCUA Board to implement the OTR violates the APA.

House Subcommittee on Financial Institutions and Consumer Credit
Hearing on National Credit Union Administration Operations and Budget
July 23, 2015

Questions for Debbie Matz, Board Chairman, National Credit Union Administration, from Congressman Brad Sherman

1. ***The Dodd-Frank Act in several places requires the CFPB to consult with federal banking regulators regarding their rulemakings.***

   a. ***To what extent does CFPB engage NCUA on their rulemaking?***

CFPB generally involves NCUA staff at multiple stages of its rulemakings. Consultation frequently occurs before CFPB prepares a draft proposed rule, after preparing a draft but before publishing it, and before publishing a final rule. CFPB typically solicits input from NCUA and other federal and representative state banking regulators.

Interagency coordination also occurs after regulations are issued. For example, working groups under the Federal Financial Institutions Examination Council develop or update interagency examination procedures based on CFPB final rules. Further, the agencies meet periodically to discuss issues associated with examination for compliance with the new rules. CFPB also participates in NCUA's online town-hall meetings and webinars for credit unions and for examiners discussing new rules.

   b. ***How does this interaction take place?***

NCUA's interaction with CFPB in connection with CFPB's rulemaking takes place through conference calls, in-person meetings, and email correspondence. Some communication with CFPB involves other federal and state agencies, and other communication is specific to NCUA.

   c. ***Which office at NCUA is responsible for interacting with the CFPB?***

The Office of Consumer Protection within NCUA interacts with CFPB for almost all of its consumer compliance rulemaking activities, and it is NCUA's office of primary interest for those rulemakings. Other offices, such as the Office of General Counsel, Office of Examination and Insurance, Office of the Chief Economist, and Office of National Examinations and Supervision may participate, as well.

   d. ***How frequently does such interaction take place?***

NCUA staff generally interact with CFPB staff several times each month, generally in connection with consultations on pending rulemakings or on implementation of new or changed rules.

e. On which rulemakings has the CFPB consulted NCUA in the past twelve months?

Rulemakings about which CFPB has consulted with NCUA staff and other federal agencies' staff during the past twelve months include potential and actual rulemakings on:

- Payday lending and other small loan products;
- Small creditor status under Regulation Z mortgage rules;
- Integrated disclosures under the Truth in Lending Act and the Real Estate Settlement Procedures Act;
- Prepaid products;
- Reporting of data under the Home Mortgage Disclosure Act;
- Larger participants in the auto financing market;
- Alternative methods of providing privacy notices;
- Mortgage servicing (force-placed insurance, early intervention, loss mitigation, successor-in-interest; bankruptcy notices and contacts; and the Fair Debt Collection Practices Act);
- Ability-to-Repay/Qualified Mortgage rules;
- Mortgage modifications; and
- Larger participants in the market for international remittance transfers.

f. To what extent does NCUA initiate consultation with the CFPB?

NCUA initiates consultation with CFPB as needed to address issues related to pending rulemakings and questions from examiners, other NCUA staff, and credit unions about CFPB rules. NCUA also initiates consultation with CFPB to enhance events NCUA conducts to provide information to its examiners and to credit unions. For example, NCUA received CFPB assistance in presenting a February 2015 webinar for credit unions on preparing to comply with the TILA-RESPA Integrated Disclosure rule. Also, Director Cordray and CFPB staff regularly participate in NCUA's online town-hall meetings and webinars for credit unions and for NCUA staff covering a variety of consumer compliance topics.

2. ***The CFPB has finalized the TILA/RESPA Integrated Disclosure regulation. Credit unions and other lenders have expressed concern with the effective date and the legal liability arising from the fact that they have no opportunity to test the new forms before they are required to use them. To make matters worse, it appears for the last 14 months, the CFPB has been telling small lenders that if they make fewer than 5 mortgage loans per year, they do not have to comply with the rule, but now it appears that information is inaccurate. NCUA will enforce the regulation for all but the very large credit unions.***

a. Will NCUA accommodate credit unions during a reasonable transition period?

Yes. I have previously noted in public communications that NCUA examiners initially will look for "reasonable and good-faith efforts by credit unions towards substantial compliance with the final rule."

b. ***What can be done to protect credit unions from the legal liability during the reasonable transition period?***

In addition to NCUA examiners recognizing credit unions' reasonable and good-faith efforts to comply, a statutory change to the Truth in Lending Act's liability provisions could strengthen credit unions' protection from legal liability during the reasonable transition period.

c. ***Are you concerned that small credit unions might be operating with misinformation regarding their obligation to comply with this rule if they're relying on inaccurate CFPB guidance?***

NCUA provided customized compliance guidance for credit unions well in advance of CFPB's effective date. In March 2015, I issued a regulatory alert to inform all federally insured credit unions of the correct standard under the Truth in Lending Act and Regulation Z for being subject to the TILA-RESPA Integrated Disclosure rule.[1] In February 2015, CFPB Director Cordray and his staff discussed the issue during my online town-hall webinar for credit unions. Specifically, CFPB staff reiterated the correct standard during the open question-and-answer segment. Approximately 1,700 registrants participated in the free webinar. One day after my webinar, NCUA hosted a second webinar about the TILA-RESPA Integrated Disclosure rule. This webinar highlighted specific compliance issues, as well.

[1] See http://www.ncua.gov/Legal/Pages/RA2015-03.aspx.